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Brokers and dealers in securities with conforming changes as of May 1, 2006; Audit and accounting guide:

American Institute of Certified Public Accountants. Stockbrokerage and Investment Banking Committee

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AICPA Audit and Accounting Guide

BROKERS AND DEALERS IN SECURITIES

*With Conforming Changes
as of May 1, 2006*

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA[®]

AICPA Audit and Accounting Guide

BROKERS AND DEALERS IN SECURITIES

***With Conforming Changes
as of May 1, 2006***

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

This edition of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, which was originally issued in 1997, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the Guide was originally issued (see page v). The changes made in the current year are identified in a schedule in Appendix P of the Guide. The changes do *not* include all those that might be considered necessary if the Guide were subjected to a comprehensive review and revision.

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Notice to Readers

This AICPA Audit and Accounting Guide (Guide) has been prepared by the AICPA Stockbrokerage and Investment Banking Committee to assist preparers of financial statements in preparing financial statements in conformity with generally accepted accounting principles and to assist auditors in auditing and reporting on such financial statements in accordance with generally accepted auditing standards.

Descriptions of accounting principles and financial reporting practices in Audit and Accounting Guides are approved by the affirmative vote of at least two-thirds of the members of the Accounting Standards Executive Committee, which is the senior technical body of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Statement on Auditing Standards (SAS) No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, identifies AICPA Audit and Accounting Guides that have been cleared by the Financial Accounting Standards Board (FASB) as sources of accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. This Audit and Accounting Guide has been cleared by the FASB. AICPA members should consider the accounting principles described in this Audit and Accounting Guide if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatments specified by this Audit and Accounting Guide should be used, or the member should be prepared to justify another treatment, as discussed in paragraph 7 of SAS No. 69.*

This AICPA Audit and Accounting Guide, which contains auditing guidance, is an interpretive publication pursuant to SAS No. 95, *Generally Accepted Auditing Standards*. Interpretive publications are recommendations on the application of SASs in specific circumstances, including engagements for entities in specialized industries. Interpretive publications are issued under the authority of the Auditing Standards Board. The members of the Auditing Standards Board have found this Guide to be consistent with existing SASs.

An auditor should be aware of and consider interpretive publications applicable to his or her audit. Interpretive publications are not as authoritative as a pronouncement of the ASB, however, if an auditor does not apply the auditing guidance included in an applicable AICPA Audit and Accounting Guide, the auditor should be prepared to explain how he or she complied with the

* In April 2005, the FASB issued an exposure draft of a proposed statement, *The Hierarchy of Generally Accepted Accounting Principles*, objectives of which include moving responsibility for the GAAP hierarchy for nongovernmental entities from the AICPA (SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*) to FASB literature. Additionally, the proposed Statement expands the sources of category (a) to include accounting principles that are issued after being subject to the FASB's due process (including, but not limited to, FASB Staff Positions and FASB Statement 133 Implementation Issues, which are currently not addressed in SAS No. 69.)

Among other matters, the proposed FASB Statement would not carry forward the Rule 203 exception from paragraph 7 of SAS No. 69. Accordingly, the proposed FASB Statement states that an enterprise shall not represent that its financial statements are presented in accordance with GAAP if its selection of accounting principles departs from the GAAP hierarchy set forth in this Statement and that departure has a material impact on its financial statements.

In response to the proposed FASB Statement, in May 2005, the AICPA issued an exposure draft of a proposed SAS, *Amendment to Statement on Auditing Standards No. 69 for Nongovernmental Entities*, which deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The final FASB Statement and SAS on GAAP hierarchy will be issued concurrently and will have a uniform effective date. For more information please visit the FASB Web site at www.fasb.org and the AICPA Web site at www.aicpa.org.

SAS provisions addressed by such auditing guidance. The specific terms used to define professional requirements in the SASs are not intended to apply to interpretive publications since interpretive publications are not auditing standards. It is the ASB's intention to make conforming changes to the interpretive publications over the next several years to remove any language that would imply a professional requirement where none exists.

Public Accounting Firms Registered with the PCAOB

Subject to the Securities and Exchange Commission (Commission) oversight, Section 103 of the Sarbanes-Oxley Act (Act) authorizes the Public Company Accounting Oversight Board (PCAOB) to establish auditing and related attestation, quality control, ethics, and independence standards to be used by registered public accounting firms in the preparation and issuance of audit reports as required by the Act or the rules of the Commission. Accordingly, public accounting firms registered with the PCAOB are required to adhere to all PCAOB standards in the audits of issuers, as defined by the Act, and other entities when prescribed by the rules of the Commission.

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This edition of the Audit and Accounting Guide *Brokers and Dealers in Securities*, has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the Guide was originally issued. Relevant accounting and auditing guidance contained in official pronouncements issued through May 1, 2006 have been considered in the development of this edition of the Guide. This includes relevant guidance issued up to and including the following:

- FASB Statement No. 156, *Accounting for Servicing of Financial Assets*, and Revised FASB Statements issued through May 1, 2006, including
 - FASB Statement No. 123 (revised 2004), *Share-Based Payment*
- FASB Interpretation No. 47 (revised December 2003), *Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143*
- FASB Technical Bulletin 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*
- FASB Staff Positions issued through May 1, 2006
- FASB Emerging Issues Task Force (EITF) consensus positions adopted at meetings of EITF held through March 2006
- Practice Bulletin No. 15, *Accounting by the Issuer of Surplus Notes*
- SAS No. 103, *Audit Documentation*
- SOP 06-1, *Reporting Pursuant to the Global Investment Performance Standards*
- SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements*
- PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*

The changes made for the current year are identified in a schedule in Appendix N of the Guide. The changes do *not* include all those that might be considered necessary if the Guide were subjected to a comprehensive review and revision.

Users of this Guide should consider pronouncements issued subsequent to those listed above to determine their effect on entities covered by this Guide.

Preface

Purpose

This American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide has been prepared to assist brokers and dealers (broker-dealers) in securities in preparing financial statements in conformity with generally accepted accounting principles (GAAP) and to assist independent accountants in reporting on financial statements (and other written management assertions) of those entities.

Applicability*

This Guide applies to preparation and audit of financial statements of entities that are broker-dealers in securities. The activities of broker-dealers in securities are described in Chapter 1. Operations of such entities are subject to the rules and regulations of the Securities and Exchange Commission and other regulatory bodies.

Broker-dealers in securities are subject to regulation under the Securities Exchange Act of 1934. Some broker-dealers are also futures commission merchants for commodity futures and commodity option contracts subject to regulation under the Commodity Exchange Act.[†]

Members of the National Association of Securities Dealers, Inc. (NASD) are subject to the rules of that association, and members of securities exchanges are also subject to the rules of the exchanges of which they are members. Some of these rules, as currently in effect, are discussed in this Guide. However, the rules, regulations, practices, and procedures of the securities and commodities futures industries have changed frequently and extensively in recent years. Still further changes are under consideration as this Guide goes to press, and the *auditor should keep abreast of these changes*.

Limitations

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

* 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, amends footnote 13 to Chapter 7 of the Investment Companies Guide to clarify that only investment partnerships regulated as brokers and dealers in securities under the Securities Exchange Act of 1934 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 but will have to follow the Investment Companies Guide which requires a schedule of investments and financial performance information.

† The Commodity Practice Aid Task Force of the AICPA is in the process of revamping the *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools* practice aid to reflect changes in accounting and auditing guidance and regulatory rules that occurred since the original issuance of this publication. The revised practice aid will provide practitioners with nonauthoritative, practical guidance on auditing financial statements of futures commission merchants, introducing brokers, and commodity pools. Readers should be alert to further developments.

Consulting the accounting and financial reporting and auditing sections of the Guide cannot take the place of a careful reading of specified authoritative literature. Other professional literature and authoritative guidance that may be issued by the Accounting Standards Executive Committee (AcSEC), the Financial Accounting Standards Board (FASB), including its Emerging Issues Task Force (EITF), the Auditing Standards Board (ASB) or the Public Company Accounting Oversight Board (PCAOB) may affect audits of the financial statements of broker-dealers. Further, the nature, timing, and extent of audit procedures applied in a financial audit is ultimately determined by the independent accountant in the circumstances. The procedures discussed in the auditing section of the Guide are not intended to be comprehensive and, performed by themselves, would not necessarily constitute an audit in accordance with generally accepted auditing standards (GAAS). Nor would omission of certain procedures set forth in the Guide necessarily result in a violation of GAAS. Internal control over financial reporting and possible tests of controls are discussed in the context of a financial statement audit. While they may correspond to controls that are subject to procedures performed in an engagement performed in accordance with PCAOB standards or SSAEs, internal control over financial reporting and possible tests of controls are not presented in that context and are not intended to address the considerations of such engagements.

Impact on Other Literature

This Guide supersedes the AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities*.

The Guide incorporates and supersedes SOP 90-3, *Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position*, to the extent SOP 90-3 amended previous editions of the AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities*. The Guide incorporates and supersedes the following SOPs:

- a. SOP 89-1, *Reports on Audited Financial Statements of Brokers and Dealers in Securities*
- b. SOP 89-4, *Reports on the Internal Control Structure in Audits of Brokers and Dealers in Securities*

Effective Date and Transition

For accounting and financial reporting provisions of this Guide that describe other authoritative literature, effective dates should be applied as provided for in the related literature. All other accounting and financial reporting provisions of the Guide, shall be effective for annual financial statements issued for fiscal years beginning after December 15, 1997, and for interim financial statements issued after initial application. The auditing provisions of this Guide shall be applied prospectively to audits of broker dealers' financial statements for fiscal years ending after December 15, 1997. Earlier application of the accounting, financial reporting, and auditing provisions of this Guide is permitted but not required.

This Guide requires two changes in financial reporting: (1) it does not allow combining of subordinated debt with stockholders' equity and (2) it requires that delayed delivery transactions be reported in the statement of condition on the settlement (delivery) date instead of the trade date.

The changes are effective for annual financial statements issued for fiscal years beginning after December 15, 1997. If comparative annual financial statements are presented for earlier periods, restatement is recommended but not required.

Auditing Guidance Included in This Guide and References to AICPA and PCAOB Professional Standards

This Guide presents auditing guidance to help the reader implement auditing standards included in both AICPA professional standards ("GAAS") and in PCAOB professional standards. In citing the professional standards, references are made to the AICPA's *Professional Standards* publication and the AICPA's *PCAOB Standards and Related Rules* publication, depending upon the applicable professional standards. Additionally, when referencing professional standards, this Guide cites section numbers and not the original statement number, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54 is referred to as AU section 317.

New Auditing Standards Related to Risk Assessment

(**Note:** This discussion is applicable to audits of privately held entities or other "non issuers." The term "issuer" means entities that are subject to the rules and regulations of the U.S. Securities and Exchange Commission and the Sarbanes/Oxley Act of 2002.)

In March 2006, the AICPA's Auditing Standards Board (ASB) issued eight Statements on Auditing Standards (SASs) that provide extensive 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 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. The following table lists the eight SASs and their effect on existing standards:

<i>Statement on Auditing Standards</i>	<i>Effect on Existing Standards</i>
SAS No. 104, <i>Amendment to Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures ("Due Professional Care in the Performance of Work")</i>	Amends SAS No. 1, section 230, <i>Due Professional Care in the Performance of Work</i> (AU sec. 230)
SAS No. 105, <i>Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards</i>	Amends SAS No. 95, <i>Generally Accepted Auditing Standards</i> (AU sec. 150)
SAS No. 106, <i>Audit Evidence</i>	Supersedes SAS No. 31, <i>Evidential Matter</i> (AU sec. 326)
SAS No. 107, <i>Audit Risk and Materiality in Conducting an Audit</i>	Supersedes SAS No. 47, <i>Audit Risk and Materiality in Conducting an Audit</i> (AU sec. 312)

(continued)

<i>Statement on Auditing Standards</i>	<i>Effect on Existing Standards</i>
SAS No. 108, <i>Planning and Supervision</i>	Supersedes SAS No. 1, section 310, <i>Appointment of the Independent Auditor</i> (AU sec. 310); and supersedes SAS No. 22, <i>Planning and Supervision</i> (AU sec. 311)
SAS No. 109, <i>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</i>	Supersedes SAS No. 55, <i>Consideration of Internal Control in a Financial Statement Audit</i> (AU sec. 319)
SAS No. 110, <i>Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained</i>	Supersedes SAS No. 45, <i>Omnibus Statement on Auditing Standards—1983, "Substantive Tests Prior to the Balance-Sheet Date"</i> (AU sec. 313); and together with Statement on Auditing Standards No. 109, supersedes SAS No. 55, <i>Consideration of Internal Control in a Financial Statement Audit</i> (AU sec. 319)
SAS No. 111, <i>Amendment to Statement on Auditing Standards No. 39, Audit Sampling</i>	Amends SAS No. 39, <i>Audit Sampling</i> (AU sec. 350)

Key Provisions of the SASs

The SASs emphasize the linkage between understanding the entity, assessing risks, and the design of further audit procedures. The SASs introduce the concept of risk assessment procedures, which are deemed necessary to provide a basis for assessing the risk of material misstatement. Risk assessment procedures along with further audit procedures, which consist of tests of controls and substantive tests, provide the audit evidence to support the auditor's opinion of the financial statements. According to the SASs, the auditor should perform risk assessment procedures to gather information and gain an understanding of the entity and its environment; including its internal controls, these procedures include inquiries, analytical procedures, and inspection and observation. Assessed risks and the basis for those assessments should be documented; therefore, auditors may no longer default to maximum control risk for an entity's risk assessment without documenting the basis for that assessment. The SASs also require auditors to consider and document how the risk assessment at the financial statement level affects individual financial statement assertions, so that auditors may tailor the nature, timing, and extent of their audit procedures to be responsive to their risk assessment. It is anticipated that generic audit programs will not be appropriate for all audit engagements, as risks vary between entities.

Effective Date and Implementation

The SASs are effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. In most cases, implementation of the SASs will result in an overall increased work effort by the audit team, particularly in the year of implementation. It also is anticipated that to implement the SASs appropriately, many firms will have to make

significant revisions to their audit methodologies and train their personnel accordingly. Readers can obtain the SASs at www.cpa2biz.com.

Applicability of Requirements of the Sarbanes-Oxley Act of 2002, Related Securities and Exchange Commission Regulations, and Standards of the Public Company Accounting Oversight Board

Publicly-held companies and other "issuers" (see definition below) are subject to the provisions of the Sarbanes-Oxley Act of 2002 (Act) and related Securities and Exchange Commission (SEC) regulations implementing the Act. Their outside auditors are also subject to the provisions of the Act and to the rules and standards issued by the PCAOB.

Section 205(c)(2) of the Act amended Section 17 (15 U.S.C. 78q) of the Securities Exchange Act of 1934 to require *all* broker-dealers (both public and private) to be audited by a public accounting firm registered with the PCAOB. However, on December 7, 2005, 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 for fiscal years ending before January 1, 2007 (see Release No. 34-52909 at www.sec.gov). The original Order, issued on August 4, 2003, and extended on July 14, 2004, was set to expire on January 1, 2006.

Presented below is a summary of certain key areas addressed by the Act, the SEC, and the PCAOB that are particularly relevant to the preparation and issuance of an issuer's financial statements and the preparation and issuance of an audit report on those financial statements. However, the provisions of the Act, the regulations of the SEC, and the rules and standards of the PCAOB are numerous and are not all addressed in this section or in this Guide. Issuers and their auditors should understand the provisions of the Act, the SEC regulations implementing the Act, and the rules and standards of the PCAOB, as applicable to their circumstances.

Definition of an Issuer

The Act states that the term "issuer" means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) (15 U.S.C. 78o(d)), or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn.

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

Non-issuers are those entities not subject to the Act or the rules of the SEC.

Guidance for Issuers

Management Assessment of Internal Control

As directed by Section 404 of the Act, the SEC adopted final rules requiring companies subject to the reporting requirements of the Securities Exchange

Act of 1934, other than registered investment companies and certain other entities, to include in their annual reports a report of management on the company's internal control over financial reporting. See the SEC web site at www.sec.gov/rules/final/33-8238.htm for the full text of the regulation.

Companies that are "accelerated filers," as defined in Exchange Act Rule 12b-2, are required to comply with these rules for fiscal years ending on or after November 15, 2004. "Non-accelerated filers" and foreign private issuers filing their annual reports on Form 20-F or 40-F must begin to comply with the rules for the first fiscal year ending on or after July 15, 2006. See the SEC web site at www.sec.gov/rules/final/33-8545.htm for further information.

The SEC rules clarify that management's assessment and report is limited to *internal control over financial reporting*. The SEC's definition of internal control encompasses the Committee of Sponsoring Organizations of the Treadway Commission (COSO) definition but the SEC does not mandate that the entity use COSO as its criteria for judging effectiveness.

Under the SEC rules, the company's annual 10-K must include:

1. Management's Annual Report on Internal Control Over Financial Reporting
2. Attestation Report of the Registered Public Accounting Firm
3. Changes in Internal Control Over Financial Reporting

The SEC rules also require management to evaluate any change in the entity's internal control that occurred during a fiscal quarter and that has materially affected, or is reasonably likely to materially affect, the entity's internal control over financial reporting.

Audit Committees and Corporate Governance

Section 301 of the Act establishes requirements related to the makeup and the responsibilities of an issuer's audit committee. Among those requirements—

- Each member of the audit committee must be a member of the board of directors of the issuer, and otherwise be independent.
- The audit committee of an issuer is directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer.
- The audit committee shall establish procedures for the "receipt, retention, and treatment of complaints" received by the issuer regarding accounting, internal controls, and auditing.

In April 2003, the SEC adopted a rule to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by the Act.

Disclosure of Audit Committee Financial Expert and Code of Ethics

In January 2003, the SEC adopted amendments requiring issuers, other than registered investment companies, to include two new types of disclosures in their annual reports filed pursuant to the Securities Exchange Act of 1934. These amendments conform to Sections 406 and 407 of the Act and relate to disclosures concerning the audit committee's financial expert and code of ethics relating to the companies' officers. An amendment specifies that these disclosures are only required for annual reports.

Certification of Disclosure in an Issuer's Quarterly and Annual Reports

Section 302 of the Act requires the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) of each issuer to prepare a statement to accompany the audit report to certify the "appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer."

In August 2002, the SEC adopted final rules for Certification of Disclosure in Companies' Quarterly and Annual Reports in response to Section 302 of the Act. CEOs and CFOs are now required to certify the financial and other information contained in quarterly and annual reports.

Improper Influence on Conduct of Audits

Section 303 of the Act makes it unlawful for any officer or director of an issuer to take any action to fraudulently influence, coerce, manipulate, or mislead any auditor engaged in the performance of an audit for the purpose of rendering the financial statements materially misleading. In April 2003, the SEC adopted rules implementing these provisions of the Act.

Disclosures in Periodic Reports

Section 401(a) of the Act requires that each financial report of an issuer that is required to be prepared in accordance with generally accepted accounting principles (GAAP) shall "reflect all material correcting adjustments . . . that have been identified by a registered accounting firm . . ." In addition, "each annual and quarterly financial report . . . shall disclose all material off-balance sheet transactions" and "other relationships" with "unconsolidated entities" that may have a material current or future effect on the financial condition of the issuer.

In January 2003, the SEC adopted rules that require disclosure of material off-balance sheet transactions, arrangements, obligations, and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses. The rules require an issuer to provide an explanation of its off-balance sheet arrangements in a separately captioned subsection of the Management's Discussion and Analysis section of an issuer's disclosure documents.

Guidance for Auditors

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

Applicability of Generally Accepted Auditing Standards and Public Company Accounting Oversight Board Standards

The Act authorizes the PCAOB to establish auditing and related attestation, quality control, ethics, and independence standards to be used by registered

public accounting firms in the preparation and issuance of audit reports for entities subject to the Act or the rules of the SEC. Accordingly, public accounting firms registered with the PCAOB are required to adhere to all PCAOB standards in the audits of "issuers," as defined by the Act, and other entities when prescribed by the rules of the SEC.

For those entities not subject to the Act or the rules of the SEC, the preparation and issuance of audit reports remain governed by GAAS as issued by the ASB. SEC Interpretive Release No. 33-8422 specifies that effective May 24, 2004, references in SEC rules and staff guidance and in the 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. Because the PCAOB has not established particular auditing standards for nonissuer broker-dealers, this release is not applicable to such engagements and related filings.

Major Existing Differences Between GAAS and PCAOB Standards

The major differences between GAAS and PCAOB standards are described in both Part I of volume one of the AICPA *Professional Standards* and in Part I of the AICPA publication titled, *PCAOB Standards and Related Rules*.

Auditor Reports to Audit Committees

Section 204 of the Act requires the accounting firm to report to the issuer's audit committee all "critical accounting policies and practices to be used . . . all alternative treatments of financial information within [GAAP] that have been discussed with management . . . ramifications of the use of such alternative disclosures and treatments, and the treatment preferred" by the firm.

Other Requirements

The Act contains requirements in a number of other important areas, and the SEC has issued implementing regulations in certain of those areas as well. For example,

- The Act prohibits auditors from performing certain non-audit or non-attest services. The SEC adopted amendments to its existing requirements regarding auditor independence to enhance the independence of accountants that audit and review financial statements and prepare attestation reports filed with the SEC. This rule conforms the SEC's regulations to Section 208(a) of the Act and, importantly, addresses the performance of non-audit services.
- The Act requires the lead audit or coordinating partner and the reviewing partner to rotate off of the audit every 5 years. (See SEC Releases 33-8183 and 33-8183A for SEC implementing rules.)
- The Act directs the PCAOB to require a second partner review and approval of audit reports (concurring review).
- The Act states that an accounting firm will not be able to provide audit services to an issuer if one of that issuer's top officials (CEO, Controller, CFO, Chief Accounting Officer, etc.) was employed by the firm and worked on the issuer's audit during the previous year.

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Chapter 1

The Securities Industry

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

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

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

- Brokers and dealers
- The financial markets (exchange markets and over-the-counter markets)
- Clearing organizations and depositories
- Transfer agents and registrars
- Regulatory agencies

Brokers and Dealers

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

- Underwriting, or participating in the underwriting of, publicly offered securities.
- Assisting in the private placement of securities.
- Providing investment research and advice.
- Developing new financial products, including derivative products.

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

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

Discount Brokers

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

Investment Bankers

1.07 Investment bankers are broker-dealers who assist in bringing new securities to the investing public. The three major functions of investment

bankers are origination, underwriting, and distribution. New securities are created during origination, bought by investment bankers during underwriting, and sold to investors during the distribution phase. Investment banking revenues are derived principally from fees for services and from price spreads from underwriting securities issues.

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

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

1.09 Investment banking firms often buy (or underwrite) a new issue or guarantee its sale at a specified price. If the securities are not sold to investors at the offering price, the investment banker may be required to buy the securities for its own account. To sell the issue quickly, a syndicate of many firms is often formed for each issue, and the securities are distributed through a large network reaching many potential investors. Historically, large syndicates, composed of many firms, were formed to create networks for selling issues quickly. Although this process continues for initial public offerings of equity securities, the advent of the shelf registration process for certain debt securities has increased the speed with which these issues are brought to market. As a result, the underwriters that usually make up the underwriting group for distributing these securities are fewer and have larger capital bases.

Government Securities Dealers

1.10 U.S. government securities dealers are a group of dealer firms that underwrite and trade U.S. government and federal agency securities. Certain of these firms are designated by the Federal Reserve Bank of New York as primary dealers in U.S. government securities, and they deal directly with U.S. government fiscal agents (the Federal Reserve Banks) in acquiring new securities issues. These dealers make a market in most U.S. government and federal agency securities and, as such, quote bid and asked prices. In addition to complying with the rules and regulations promulgated by the SEC pursuant to the Federal Securities Laws, these broker-dealers are also subject to certain rules and regulations of the Department of the Treasury. See paragraph 3.139 for specific rule provisions relating to Government Securities Dealers.

Specialists

1.11 A specialist is a broker-dealer authorized by an exchange to be a party through which all trading on the floor of the exchange in a particular security is transacted. A specialist provides for a fair and orderly market for the selected list of securities it is authorized to trade. The specialist must generally be ready

to take the other side of a transaction if other buyers or sellers are not available. The specialist also maintains a book of limit orders and acts as a brokers' broker in executing these limit orders against incoming market orders.

Clearing Brokers

1.12 A clearing broker is a broker-dealer who receives and executes customers' instructions, prepares trade confirmations, settles the money related to the trades, arranges for the physical movement of the securities, and shares responsibility with the introducing brokers for compliance with regulatory requirements.

Carrying Brokers

1.13 A carrying broker is a broker-dealer that holds customer accounts for introducing broker-dealers. Typically, this type of firm is also a clearing firm for those introducing firms. A carrying broker-dealer is responsible for performing the Customer Reserve Computation and Possession and Control requirements of SEC rule 15c3-3. A carrying broker-dealer may carry customer accounts on an omnibus or fully-disclosed basis. See paragraphs 5.134–5.139 for a discussion of omnibus and fully-disclosed accounts.

Prime Brokers

1.14 Prime brokerage is a system developed by full-service broker-dealers to facilitate the clearance and settlement of securities trades for substantial retail and institutional customers who are active market participants. Prime brokerage involves three distinct parties: the prime broker, the executing broker, and the customer. The prime broker is the broker-dealer that clears and finances the customer trades executed by one or more executing broker-dealers at the behest of the customer. Most prime brokerage agreements are executed with hedge funds.

Introducing Brokers

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

Brokers' Brokers

1.16 A brokers' broker is a broker-dealer firm that acts as an agent for an undisclosed principal (another broker-dealer) for the purchase and sale of treasury, municipal, and corporate debt securities. These firms do not maintain securities inventories. Brokers' brokers play a significant role in the secondary market as intermediaries for trades between broker-dealers. Brokers' brokers typically provide the bid/ask prices for securities of their client, on an

undisclosed basis, on trading screens of the brokers' broker, and then match up buyers and sellers. Brokers' brokers commonly deal in treasury, municipal, and corporate bond trading businesses for which no exchanges are available. Some brokers' brokers concentrate in certain kinds of securities and act as intermediaries for registered dealers and receive commissions that are usually determined by the size of the transaction.

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

1.17 A Section 20 broker was established by a bank pursuant to Section 20 of the Glass-Steagall Act of 1933. The Gramm-Leach-Bliley Act of 1999, also known as the Financial Services Modernization Act, repealed Section 20 of the Glass Steagall Act of 1933, and changed the types of activities that are permissible for bank holding company affiliates and for subsidiaries of banks, creating so-called "financial holding companies" that may engage in a broad array of activities. Financial holding company affiliates, as well as direct subsidiaries of banks, may now engage in underwriting, dealing in, or making a market in securities. Broker-dealers of financial holding companies are now subject to the rules pursuant to Section 4k4(e) of the Gramm-Leach-Bliley Act of 1999. The Gramm-Leach-Bliley Act of 1999 affirmed the concept of functional regulation. Federal banking regulators will continue to be primary supervisors of the banking affiliates of financial holding companies, and the SEC and securities self-regulatory organizations will supervise the securities businesses of those entities.

The Financial Markets

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

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

1.20 Financial markets may also be characterized according to whether a party must find the counterparty to a trade and negotiate with that

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

Exchange Market*

1.21 An exchange market is a central meeting place established to facilitate the trading of securities or commodities. A securities exchange is an exchange market that provides trading facilities for stocks, bonds, or options. Exchange markets are generally characterized as auction places where bids and offers are directed and executed by brokers or specialists.

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

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

1.24 With the advent of advanced electronic switching capabilities, certain exchanges have provided their members with the facility of direct order entry to floor specialists. For example, the New York Stock Exchange (NYSE) XPress Orders system provides for an immediate execution of block orders greater than 15,000 shares whenever a quote is in place for at least 15 seconds. Another NYSE system, Anonymous SuperDOT, enables member firms to entitle their institutional customers to route orders directly to the NYSE for electronic execution without having their identities revealed.

Over-the-Counter Market

1.25 Many companies have insufficient shares outstanding, stockholders, or earnings to meet the listing requirements of an exchange or, for other reasons,

* In April 2005, the SEC adopted Regulation National Market System (NMS), which contains four interrelated proposals designed to modernize the regulatory structure of the U.S. equity markets. The substantive topics addressed by Regulation NMS are (1) order protection, (2) intermarket access, (3) sub-penny pricing, and (4) market data. In addition, Regulation NMS updates the existing Exchange Act rules governing the national market system, and consolidates them into a single regulation. Finally, two amendments were made to the joint industry plans for disseminating market information (Plans). See SEC Release No. 34-51808 for more information.

choose not to be listed. Securities of these companies are traded in the OTC market between dealers that act either as principals or as brokers for customers.

1.26 The OTC market is not a location; rather, it is a communications network linking those dealers that make markets in securities generally not listed on exchanges. An offer to buy or sell an unlisted security is executed by a broker-dealer entering into a transaction with a customer or another broker-dealer that makes a market in that security.

1.27 The broker-dealer may act for its own account (as principal) in a purchase or sale transaction with a customer or another broker-dealer. In such cases, no commission is charged; instead, the broker-dealer realizes a profit or loss based on the spread between the cost and selling price of the securities.

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

1.29 Price quotations for major OTC equity securities are available on the National Association of Securities Dealers Automated Quotation (NASDAQ) System. Other price quotations for various OTC securities not listed on the system can be found on the pink sheets for equity securities, yellow sheets for corporate bonds, or blue lists for municipal securities. These quotations represent indications of buying and selling interests rather than firm prices.

Third Market

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

Alternative Trading Venues

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

1.32 One of the biggest developments over the past several years is electronic communications networks (ECNs). An ECN is an electronic system that brings buyers and sellers together for the electronic execution of trades. Those who subscribe to ECNs, generally institutional investors, broker-dealers, and market-makers, can place trades directly on the ECN, typically using limit orders. ECNs post orders on their system for other subscribers to view. The ECN will then automatically match orders for execution. If a subscriber wants to buy a stock through an ECN, but there are no sell orders to match the buy order, the order cannot be executed until a matching sell order comes in. If the order

is placed through an ECN during regular trading hours, an ECN that cannot find a match may send the order to another market center for execution.

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

Clearing Organizations and Depositories

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

1.35 The exchange markets have sponsored central clearing agencies, known as *clearing organizations*, to assist in the comparison, clearance, and settlement functions. Deliveries and receipts of securities and the related cash settlements are made through these clearing organizations for broker-dealers. The National Securities Clearing Corporation (NSCC), the largest U.S. clearing organization, is owned by the New York and American Stock Exchanges and the National Association of Securities Dealers, Inc. (NASD). The Stock Clearing Corporation of Philadelphia and the Midwest Clearing Corporation also facilitate the settlement of securities transactions. In the OTC market, clearance may be accomplished by a variety of methods, including the buying and selling of broker-dealers' exchange-of-trade tickets directly with one another or through a clearing organization. Introducing broker-dealers operating through clearing brokers settle their transactions through those clearing brokers, who in turn settle the transactions through the clearing organizations. The Options Clearing Corporation (OCC) and the clearing organizations of the commodity exchanges perform similar functions for options and futures trading. Clearance of securities traded on international markets is accomplished in a variety of ways ranging from centralized clearing organizations to corporations whose securities are cleared by major banking organizations.

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

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

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

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

1.39 Some of the major depositories are the Depository Trust Company (DTC), Midwest Securities Trust Company (MSTC), the Philadelphia Depository Trust Company (PDTC) for equities and corporate and municipal debt securities, and the Mortgage-Backed Securities Clearing Corporation (MBSCC) for certain eligible mortgage-backed securities. MBSCC maintains open to be announced (TBA) commitments for members. In addition, the Participants Trust Company (PTC) is a limited-purpose trust company that functions as a depository for Government National Mortgage Association (GNMA) physical securities. Net settlement is done on a book entry basis at PTC or at the Federal Reserve through the broker-dealer's clearing bank.

Transfer Agents

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

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

1.42 For mutual funds, transfer agents enter the amount of securities purchased by a shareholder on the issuer's books and redeem (liquidate) shares upon receipt of the customer's written or wire request. Transfer agents, as part of their transfer function, maintain records of the name and address of each

security holder, the amount of securities owned by each security holder, the certificate numbers corresponding to a security holder's position, the issue date of the security certificate, and the cancellation date of the security certificate. Many transfer agents also act as paying agents for cash dividends and the distribution of stock dividends and stock splits.

1.43 A transfer agent, performing the registrar function, monitors the issuance of securities in an issue with a view towards preventing the unauthorized issuance of securities. The registrar checks to ensure that the issuance of the securities will not cause the authorized number of shares in an issue to be exceeded and that the number of shares represented by the new certificate or certificates corresponds to the number of shares on the canceled ones. After the registrar performs these functions, the registrar countersigns the certificate.

Regulatory Overview

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

1.45 Since 1934, the Exchange Act has been amended to include virtually all participants in the securities markets and an ever-increasing range of securities-related activities. Originally, the scope of the Exchange Act was limited to the regulation of exchanges, members of exchanges, and trading in securities listed on exchanges. The Maloney Act of 1938 amended the Exchange Act to cover the OTC markets. The Maloney Act established the NASD, which is a self-regulatory organization that has responsibility for oversight of the OTC securities markets.

1.46 In 1975 the Exchange Act was amended to extend the authority of the SEC to include securities transfer agents, clearing organizations, and securities

depositories. This amendment also established the Municipal Securities Rule-making Board, which was authorized to prescribe rules regulating the activities of municipal securities broker-dealers. In 1986, the Exchange Act was amended by the Government Securities Act of 1986 (GSA), to require U.S. government securities broker-dealers to register with the SEC. Under the GSA, the SEC has the authority to enforce rules promulgated by the Department of the Treasury that concern U.S. government securities broker-dealers. Thus, the Exchange Act today provides a comprehensive scheme of regulation for virtually all broker-dealers in securities, the exchanges, and the OTC markets, as well as the facilities for clearing and settling transactions between broker-dealers, depositories, transfer agents, and registrars.

1.47 The Securities Investors Protection Corporation (SIPC) was established when Congress enacted the Securities Investor Protection Act of 1970 (SIPA). SIPC is a nonprofit membership corporation designed to protect, up to a specific maximum amount, customers' cash and securities in the custody of a broker-dealer that fails and is liquidated under SIPA. Broker-dealers registered with the SEC, with some limited exceptions, are required to be members of SIPC. Broker-dealer firms that limit their business exclusively to certain mutual fund and insurance activities and broker-dealers whose securities business is limited to U.S. government securities and who are registered with the SEC under a provision that does not confer SIPC membership are excluded from SIPC membership. The money required to protect customers beyond that which is available from the customer property in the possession of the failed broker-dealer is advanced by SIPC from a fund maintained for that purpose. The sources of money for this fund are assessments collected from SIPC members and interest on the fund's investments in U.S. government securities made with the funds collected.

Business Activities

Brokerage

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

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

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

transaction. In general, the broker-dealer will hold the customer responsible for any resulting deficiency.

1.51 If a customer sells securities, the customer must promptly deliver the certificates to the broker-dealer. Either the proceeds of a sale will be credited to the customer's account on the settlement date or, if requested, a check will be mailed to the customer. In general, under SEC rule 15c3-3, if the broker-dealer does not receive the securities sold within ten business days of the settlement date, the broker-dealer is required to close the transaction with the customer by purchasing securities of like kind and quantity. Again, the broker-dealer will hold the customer responsible for any resulting loss.

1.52 *Margin Accounts.* Under Regulation T, the broker-dealer is required to record the purchase or sale of securities by customers on other than immediate cash settlement terms in a margin account. A purchase on margin contemplates a prolonged extension of credit to the customer by the broker-dealer. The maximum amount of initial credit is prescribed by Regulation T. The maximum amount of credit the broker-dealer can extend beyond the initial transaction is prescribed by the rules of the appropriate self-regulatory organization (for example, rule 431 of the NYSE). Customer margin requirements relating to securities futures are prescribed by joint final rules issued by the SEC and CFTC in August 2002.

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

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

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

1.56 In contrast, an omnibus account is an account of the initiating broker that is carried on the books of the clearing broker and that represents the sum of the activity of customers of the initiating broker. The initiating broker's

customer accounts are carried separately on the books of the initiating broker. For an omnibus account, the initiating broker prepares and sends confirmations and monthly statements to customers, maintains customers' accounts and margin records, and retains most of the responsibility for compliance with regulatory matters.

Firm Trading

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

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

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

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

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

1.62 *When-Issued Transactions.* When issued transactions are contracts to purchase or sell securities only when, as, and if new securities are issued. Broker-dealers enter into such purchase or sale transactions on pending issues of new securities. Trading in when-issued securities normally begins when the U.S. Treasury, a municipality, state, or some other issuer of securities announces a forthcoming issue. Such transactions are contingent upon the issuance of the securities. Because the exact price and terms of the securities are unknown before the issuance date, trading prior to that date is on a yield basis, that is, based on the yields that buyers expect.

1.63 The exact terms and price of the security become known on the issuance date, and when-issued trading continues until settlement date, at which time the securities are delivered and the issuer is paid. When-issued transactions may also arise as a result of underwritings, exchanges, mergers, and so forth, after preliminary agreement to issue the securities is established but before a date for settlement has been set.

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

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

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

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

1.68 The credit risk associated with a futures contract is generally less than it is for forward contracts, because of the protections afforded by the exchange clearing organization system. All futures contracts cleared through a clearing organization are marked to market (see the Glossary), and the financial result is settled daily between the clearing organization and the clearing

member. Because of this daily settlement, the amount of unsettled credit exposures is limited to the amount owed the clearing member for any one day.

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

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

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

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

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

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

1.75 *Caps, Floors, and Collars.* An interest rate cap is a contractual agreement between two counterparties in which the buyer, in return for paying a fee, will receive cash payments from the seller at specified dates if rates go above a

specified interest rate level known as the strike rate (cap). An interest rate floor is a contractual agreement between two counterparties in which the buyer, in return for paying a fee, will receive cash payments from the seller at specified dates if interest rates go below the strike rate. The cap or floor fee (premium) is generally paid in advance to the seller by the buyer, but it may be paid over the life of the cap or floor agreement. At each settlement date during the term of the cap or floor, the strike rate is compared with the market rate (index rate) to determine whether the seller must make a payment to the buyer. The timing of these payments varies depending on the agreement between the buyer and the seller.

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

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

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

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

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

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

1.82 The term *currency swap* is also used to describe arrangements in which spot and forward foreign exchange contracts are entered into with the same counterparty (foreign exchange swap). The forward amount exchanged is different from the spot amount because the forward amount includes an interest

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

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

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

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

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

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

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

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

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

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

Investment Banking

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

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

1.94 Underwriting subjects the broker-dealer to substantial risks. A broker-dealer underwriting securities on a firm-commitment basis is required to buy a portion of the positions offered. This results in the need to finance the unsold portions and to assume the market risk of ownership. In addition, the broker-dealer may be held liable to the purchasers of the securities under the Securities Act of 1933. The statute holds all persons (including underwriters) connected with a registration statement responsible for any material misstatements contained in the registration statement. An underwriting also exposes the broker-dealer to the risk that its customers or other group members who

had committed to buy the securities being underwritten may refuse to honor the transactions.

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

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

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

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

1.99 In 1990 the SEC adopted rule 144A to provide a safe-harbor exemption from the registration requirements of the Securities Act of 1933 for the resale of private placements when the resale is made to a qualified institutional buyer. Broker-dealers can qualify as institutional buyers if they own and invest on a discretionary basis at least \$10 million in the securities of unaffiliated issuers. Broker-dealers with less than \$10 million may buy securities as riskless principals for clients that are themselves qualified institutional buyers.

Financing

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

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

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

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

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

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

1.106 *Repos or Reverse Repos.* A repo (also known as a repurchase agreement) is a transaction involving the sale of assets, usually government agency

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

1.107 A reverse repo (also known as a reverse repurchase or resale agreement) is a transaction involving the purchase of assets or securities, subject to an agreement by the purchaser to resell the assets at a specified date or in specified circumstances. The buyer is said to enter a reverse repo while the seller enters a repo. This reciprocal procedure enables the seller to obtain short-term financing while the buyer is able to earn interest on its excess cash and hold securities as collateral. For the buyer, the transaction represents another form of secured lending.

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

1.109 In a tri-party repo, an independent institution acting in a custodial capacity enters into a tripartite agreement with the two counterparties to the transaction. This third-party custodian assumes certain responsibilities for safeguarding the interests of both counterparties and is involved in transferring funds and securities between those two parties. In a deliver-out repo, the securities are delivered to the investor or its designated custodial agent, who has no relationship with the repo seller. A hold-in-custody repo is characterized by the repo seller retaining control of the securities and by serving simultaneously throughout the transaction not only as principal but also as the investor's custodial agent.

1.110 Some commonly used terms that describe various kinds of repurchase transactions include overnight repos, term repos, repos to maturity, and matched repos. Matched repos are situations in which the broker-dealer has entered into repos and reverse repos utilizing the same securities. Broker-dealers make their profits on the differences between the interest charged on the repos and the interest earned on the reverse repos.

Other Activities

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

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

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

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

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

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

[†] The Commodity Practice Aid Task Force of the AICPA is in the process of revamping the *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools* practice aid to reflect changes in accounting and auditing guidance and regulatory rules that occurred since the original issuance of this publication. The revised practice aid will provide practitioners with nonauthoritative, practical guidance on auditing financial statements of futures commission merchants, introducing brokers, and commodity pools. Readers should be alert to further developments.

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

Chapter 2

Broker-Dealer Functions, Books, and Records

Introduction

Overview

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

2.02 This chapter discusses the flow of a security transaction, whether manual or automated, and standard departments and records within a broker-dealer. The auditor may find that many of those records and activities are automated, including the execution, for example, through the Designated Order Turnaround (DOT) system, clearance, and the settlement of trades and the processing of transactions, balancing, and reconciliations of records both within the broker-dealer and with external entities such as the National Securities Clearing Corporation (NSCC) or the Depository Trust Company (DTC).

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

Original Entry Journals

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

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

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

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

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

General Ledger

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

Stock Record

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

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

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

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

- *Box.* Securities are physically located at the broker-dealer's own location, typically in the cashier's cage.

- *Vault.* Securities are physically located at the broker-dealer's own location in a secured area or in a bank safe deposit box.
- *Depositories.* Securities are on deposit at a depository, such as DTC or a custodian bank.
- *Transfer.* Securities are at a transfer agent being reregistered.
- *Fail-to-receive.* The broker-dealer has purchased securities, which have not yet been received.
- *Securities loaned.* Securities have been loaned to another broker-dealer.
- *Customer short.* A customer sold securities, but delivery has not yet been made.
- *Firm short.* The broker-dealer sold a security it does not own.
- *Repurchase agreements* (also known as repos).
- *Bank loan.* Securities are held on deposit at a bank and pledged as collateral for a loan.

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

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

Regulatory Recordkeeping Requirements

2.13 The basic requirements for preparing and maintaining books and records are described in Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934 (the Exchange Act) (see Financial Reporting Release No. 1, section 402.02, for general guidelines for maintaining current books and records in accordance with these rules). In Rule 17a-3, the SEC specifies the minimum books and records a broker-dealer must maintain. They include a complete set of financial accounting books and records, including books of original entry, general and subsidiary ledgers, and the stock record. Rule 17a-3 also sets forth other recordkeeping requirements of broker-dealers. Among other things, it requires broker-dealers to maintain a memorandum of each brokerage order and a memorandum for each purchase and sale of securities for its own account, showing the price and, to the extent feasible, the time of execution. The rule also specifies that the broker-dealer must maintain certain records regarding transactions of employees and customers, as well as a periodic trial balance and net capital, reserve formula, and other regulatory computations. Such books and records are required to be maintained for prescribed periods as set forth in Rule 17a-4. In November 2001, the SEC adopted amendments to Rule 17a-3 and the record retention requirements in Rule 17a-4. Among other things, the amendments to Rule 17a-3 revised the information that must be recorded on order tickets; added new requirements to collect certain account

record information, and periodically provide that information to customers for verification. The amendments to Rule 17a-3 also added new requirements to create: certain records related to associated persons, a record of customer complaints, a record indicating compliance with applicable advertising rules, and records identifying persons responsible for establishing procedures and persons able to explain the broker-dealer's records to a regulator.

2.14 Furthermore, in their constitutions and rules, the National Association of Securities Dealers (NASD) and many securities exchanges prescribe certain books and records that members must keep. Depending on the needs of the individual broker-dealer's business, there are situations that may warrant the maintenance of certain additional records not specifically required under the rules of the various regulatory bodies.

Trade Date and Settlement Date

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

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

Standardized Settlement Dates

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

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

2.17 Trade date information, which includes proprietary inventory reports used by a broker-dealer's traders, is normally available in the broker-dealer's internal reporting systems. In addition, customer information is used daily by

the broker-dealer to determine the amount of margin required for each customer's account. Trade date information is also important to the operations departments, to assist them in settlement and clearance.

Trade Execution

Customer Trades

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

2.19 Before initiating an order, the customer must determine the following:

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

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

2.21 Exchange trading is normally done in round lots (usually one hundred shares), and a bid and offer on a security is usually made for the minimum unit of trading. A customer must accept a partial execution, in units of trading, unless the order is marked all or none (AON) or fill or kill (FOK). A customer's order to buy or sell is generally transacted as soon as possible after its receipt on the exchange floor or in the broker-dealer's trading area. An order is considered valid only for the day of the order; however, a customer can enter an order as good till canceled (GTC) or an open order, which is valid for longer than one day. The customer can cancel a GTC order if no action has been taken before the cancellation is received. Customers may enter good-through-the-week (GTW) and good-through-the-month (GTM) orders for bonds.

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

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

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

2.24 *Order Entry.* The completed order ticket is entered into the system, which accepts and reviews the ticket and relays the customer's instructions to the exchange floor or trading desk where it is to be executed. The exchanges have developed systems, such as Designated Order Turnaround (DOT) and Super-DOT, whereby an order is routed to an automated order matching system, depending on its size or price restriction. In addition, some firms have developed internal order matching systems. Once the order has been executed, the transaction is confirmed with the customer. Information concerning executed trades is sent to the purchase and sales department, which is responsible for ensuring that system-generated trade confirmations are correct and mailed to customers.

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

2.26 Rule 17a-3 requires broker-dealers to maintain records of each purchase and sale of securities, showing the price and, to the extent possible, the time of execution. No records of dealers' quotations or bids or offers made in the course of trading are required by the rule.

2.27 An executed trades report containing the terms of the executed orders is generated daily to facilitate further processing. Executed trades reflecting the

purchase or sale of securities are recorded on a blotter, but they are generally not posted to the firm's general ledger and stock record until the settlement date. Instead, they are held in a pending file and posted on a memo basis to margin records and a bookkeeping journal.

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

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

The SEC adopted new Rule 17a-3(a)(17) requiring broker-dealers to create a customer account record with certain minimum information as to each customer, and to furnish account record information to customers on a periodic basis.

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

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

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

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

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

2.34 Regulation T establishes the maximum loan value of the securities in the account and requires the broker-dealer to obtain a deposit of cash or securities necessary to meet the initial margin requirement within two business days after the settlement date. The two-business-days-after-settlement-date period may be extended for one or more limited periods by applying to a national securities exchange or to the NASD. Maximum loan values for securities and a listing of marginable securities are prescribed periodically by a supplement to Regulation T. Certain securities exchanges have rules establishing minimum maintenance margin requirements, for example, New York Stock Exchange (NYSE) rule 431. A broker-dealer may establish initial or maintenance margin requirements that are greater than those required by the rules of the regulatory bodies.

2.35 A short sale is a sale of a security that the seller does not own. Before a broker-dealer can execute a short sale for a customer, it must know that it can obtain the security. The broker-dealer is expected to borrow the security if necessary on behalf of the customer for the purpose of satisfying the delivery requirements. Short sales are governed by the margin requirements of Regulation T and the rules of self-regulatory organizations (such as NYSE rule 431). A short sale account must be used to record transactions where securities are sold short.

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

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

2.38 To facilitate the transfer of customer accounts between broker-dealers, the NSCC has developed a system known as the Automated Customer Account Transfer (ACAT) system.

2.39 *Extension of Credit.* After a transaction is recorded, the margin department monitors the customer's trade activity and account balance to ensure that payment and delivery are satisfied in accordance with federal, exchange, and firm requirements. The margin department protects the firm by enforcing collection procedures and policies (checking credit status) and by reviewing customer account activity to ensure that the firm complies with the rules and

regulations of various regulatory agencies, such as Regulation T and the rules of self-regulatory organizations. The margin department normally—

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

2.40 Records maintained by the margin department normally indicate the following, on a trade date basis, for each margin customer:

- Market value of the securities
- Money balance of the account
- Margin excess or deficit
- Safekeeping and segregation instructions
- Pending trades
- Special miscellaneous account (SMA) balance calculated in conformity with Regulation T and the rules of self-regulatory organizations

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

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

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

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

2.44 For margin and short-sale transactions, the margin department ensures that customers deposit sufficient collateral to meet federal and exchange

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

Proprietary Trades

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

2.46 With a dealer strategy, the broker-dealer attempts to balance buy and sell transactions with different customers or other broker-dealers and earn the difference between the price paid on the purchase (bid) and the price received on the sale (ask). If a broker-dealer cannot simultaneously execute a buy and corresponding sell, the firm is at risk to market volatility during the time between execution of the purchase and execution of the sale. Hedging strategies¹ are often employed to minimize that risk.

2.47 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. Should a trader incorrectly forecast the market, losses can be incurred.

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

2.49 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 (floor specialists currently have seven business days) that it is held for investment.

2.50 Underwriter. A broker-dealer participating in underwriting activities may act as managing underwriter, comanaging underwriter, or participating underwriter. The managing underwriter is responsible for organizing the other participating underwriters and the selling group. This function is often

¹ Hedge accounting is permitted only if the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*, FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, and FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, are met.

performed jointly by two or more firms as comanagers. A managing underwriter, in addition to being a participating underwriter, typically negotiates the transaction with the issuer of the security and maintains the records of the underwriting group. A comanager takes part in the negotiations but does not maintain the records of the group.

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

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

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

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

2.55 The management fee is the fee paid to the manager or comanagers of the underwriting for services rendered in organizing the syndicate of underwriters and maintaining the records for the distribution. The underwriting fee is paid to the underwriting participants as compensation for the risk assumed through their agreement to buy a specified portion of the issue. It is usually net of the expenses directly associated with the underwriting. The selling concession is the fee paid for selling the offering.

Clearance and Settlement

Overview

2.56 Most transactions on securities exchanges and in certain active unlisted securities are cleared and settled through clearing organizations that were established to simplify and expedite the settlement of transactions

between member firms. Clearance is facilitated through continuous net settlement (CNS) systems, which minimize paperwork and the movement of securities and money. This results in one net position in each security (either to deliver or to receive) between the broker-dealer and the clearing organization. Clearing organizations prepare daily reports for members, showing the net security position (beginning balance less sales and plus purchases, plus receipts and less deliveries) by security and the net money balance that is due to or from the clearing organization.

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

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

2.58 Accrued interest earned on fixed-income securities is computed from the last coupon payment date up to the settlement date. This amount is paid to the seller of the instrument by the purchaser, who then receives the full periodic interest amount on the next coupon payment date.

2.59 The P&S department maintains the records of floor brokerage fees that are due to other broker-dealers who execute orders on the firm's behalf and brokerage fees due from other broker-dealers. Floor brokers employed by the firm may execute trades on behalf of other broker-dealers, for which the firm is paid a brokerage fee. Broker-dealers often engage floor brokers, who are responsible for executing securities transactions on the exchanges for the account of the broker-dealer. If the floor broker is employed by the broker-dealer, any costs associated with the floor broker's employment are generally reported as employee compensation. Costs paid to independent or other firms' floor brokers for trades on behalf of the firm are generally reported as floor brokerage expense.

Comparison

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

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

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

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

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

2.64 For trades that are not processed through a clearing organization, the P&S department reviews a system-generated broker-to-broker comparison, which is sent to the counterparty for verification of all pertinent trade information. If the counterparty agrees with all details of the transaction, the comparison is signed and returned to the P&S department to evidence its acceptance. If the other broker-dealer disagrees with the details of the transaction, any corrections that must be made in the firm's accounting records are recorded to enable proper settlement to occur.

Settlement

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

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

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

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

2.68 Money is paid or received daily by the broker-dealer so that the money balance in the account approximates the net market value of the open security

positions. Included in the transmittal to the clearing organization are credit lists showing the total dollar amounts due from each of the purchasing broker-dealers.

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

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

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

2.72 For deliveries to be made directly to other broker-dealers, blotters are examined and requests for the securities needed for delivery are made, usually on the business day before the settlement date. If the securities are not available after all receipts on the day before settlement, the needed security may be borrowed, in which case the stock loan department would be requested to borrow the securities from another broker-dealer. If the securities are on hand, the securities are removed from the box, checked for proper negotiability, and delivered to the purchasing broker-dealer. If the delivery matches the purchasing broker-dealer's receive instructions, the selling broker-dealer receives payment.

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

2.74 *Fails-to-Receive or Fails-to-Deliver.* A fail-to-receive is a securities purchase from another broker-dealer not received from the selling broker-dealer by the close of business on the settlement date. It is recorded as a short position on the stock record with a corresponding liability for the contract amount on the general ledger.

2.75 A fail-to-deliver is a securities sale to another broker-dealer that has not been delivered to the buying broker-dealer by the close of business on the settlement date. It is recorded as a long position on the stock record, with a corresponding receivable for the contract amount on the general ledger.

2.76 Most broker-dealers have automatic fail systems, which generate pending files containing all unsettled securities after the trade date. As

securities are settled, they are removed from the pending files. Any unsettled trades remaining on the day following the settlement date are transferred to fail files. Blotters of all open fails are forwarded to the cashiering department daily to be controlled and monitored.

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

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

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

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

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

Bookkeeping

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

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

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

Specialized Clearance Activities

Mortgage-Backed Securities

2.85 The books and records maintained by brokers and dealers in mortgage-backed securities (MBSs) are somewhat unique because of the requirements for recording receipts and payments of MBS principal and interest (P&I), maintaining records of both the original face value and amortized face value of MBSs, recording the allocation of mortgage pools to fulfill sales commitments, and maintaining records for trades for forward settlement where underlying pool numbers have yet *to be announced (TBA)*.

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

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

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

2.89 A significant amount of MBS trading occurs in TBAs. The broker-dealer must maintain accounting subledgers that reflect outstanding TBA buy and sell transactions. TBA transactions can be settled by receiving or delivering pools pursuant to the terms of the trade (within 2 percent of the trade amount), or by offsetting the trade through an offsetting TBA purchase or sale. In both

cases, accurate subledgers are important to calculate properly the pools received or delivered pursuant to the TBA transactions.

Government Securities

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

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

2.92 All primary government securities dealers and some nonprimary government securities dealers are members of a clearing agency known as the Government Securities Clearing Corporation (GSCC), which is affiliated with the NSCC. Participating government securities dealers use this net settlement system for the clearance and settlement of government securities positions. This net settlement system will net down settlements (including interest) for delivery through the Federal Reserve System. The GSCC guarantees all transactions that are already compared between participants. The settlement of transactions for government securities is done using federal funds. Government securities normally settle regular way, one business day after the trade date. They can also settle for cash (same day as the trade date) or for any mutually agreed-on settlement date.

Repos and Reverse Repos

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

2.94 Additional securities transfers or delivery of funds may be necessary over the Fed wire depending on changes in the market value of the underlying

collateral (mark-to-market). Market value changes can necessitate adjustment of the repo transaction, either by repricing or a margin call. In a repricing the change requires a delivery of funds, while a margin call requires a transfer of collateral.

Derivative Securities

2.95 FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*, FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, and FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts,^{*} and for hedging activities.² See the "Derivatives" section in Chapter 7 of this Guide for discussion of FASB Statement No. 133, as amended. Derivative products (such as interest rate and currency swaps, swaptions, caps, and floors) involve certain unique settlement procedures. The settlement of these products does not involve the delivery of physical or book entry securities, but rather involves only cash exchanges between counterparties based on interest rates and notional or contract accounts. Settlement procedures for interest rate swaps require the monitoring and calculation of the required interest payment for the floating rate cash flow and the calculation of the fixed-rate interest payment for the fixed-rate cash flow. Once these amounts are determined on the interest payment date, the cash payments are then transmitted to the appropriate counterparty by the method specified in the master swap agreement, such as wire or check. Often, a broker-dealer will have more than one swap agreement with a counterparty. If a master netting agreement is in place, the counterparty may net the interest payments or receipts and one net cash payment will be made to or from the broker-dealer on the interest payment date. The floating rate cash flow of an interest rate swap must be continually updated as specified under the terms of the swap agreement, to enable the broker-dealer to calculate the interest payment or receipt from the contract and also to calculate unrealized gain or loss on a contract.

^{*} In February of 2006 the FASB issued FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*, which permits fair value remeasurement for hybrid financial instruments (on an instrument-by-instrument basis) that contain an embedded derivative that would otherwise require bifurcation. The fair value remeasurement election is irrevocable once selected. All changes in fair value for the entire hybrid instrument (whether an asset or a liability) are recognized in earnings, as opposed to bifurcating an embedded derivative and applying fair value only to the derivative. If the fair value election is made, the hybrid financial instrument may not be designated as a hedging instrument in a FASB Statement No. 133 hedge. See the "Derivatives" section in Chapter 7 of this Guide for an additional discussion of the requirements of FASB Statement No. 155.

FASB Statement No. 155 is effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of FASB Statement No. 155 may also be applied upon its adoption for hybrid financial instruments that had been bifurcated under paragraph 12 of FASB Statement No. 133 prior to the adoption of FASB Statement No. 155. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period, for that fiscal year.

² Broker-dealers mark investments in trading securities and hedges to market. Auditors should be aware of this practice as they review the provisions of FASB Statement No. 133, as amended.

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

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

Commodity Futures and Options on Futures

2.98 The underlying commodities in the commodity futures contracts currently traded include grains, soybeans, rice, potatoes, sugar, coffee, and other foodstuffs; cotton; meat products, such as live and feeder cattle, pork bellies and live hogs, and broilers (chickens); precious and other metals, including gold, silver, copper, palladium, and platinum; foreign currencies; and energy products such as crude oil, heating oil, and leaded and unleaded gasoline. Contracts in financial instruments such as U.S. treasury bills, bonds and notes, Government National Mortgage Association (GNMA) securities, bank certificates of deposits, and Eurodollars are traded by those who wish to speculate or hedge using various interest rate futures. Also, stock index futures contracts are used for hedging portfolios⁴ or for speculating against changes in stock market prices. Most commodity futures contracts can be settled by taking or making delivery of the actual underlying commodity. Futures on stock market indexes and certain other futures are settled in cash. Exchange-traded options on futures contracts must be settled through the delivery of the related futures contract by book entry. Although a futures contract may be settled by delivery, virtually all of the commodity futures and option contracts are not settled by delivery, but rather with an offsetting purchase or sale of the same futures or options contract.

2.99 *Clearing Organization for Settlement of Commodity Futures and Option Contracts.* A clearing organization is affiliated with a commodity exchange to clear or match trades executed on that exchange. The clearing organization, which is composed of clearing members, prepares daily settlement reports for each member. The reports show details of the trades cleared and the original margin on futures or premium deposits on options separately for customer and noncustomer trades. The open trades at the close of business each day are marked to market (trade price versus settlement price), resulting in a net cash payment to or collection from each clearing member as a result of price changes

⁴ Hedge accounting is permitted only if the requirements of FASB Statement No. 133, as amended, are met.

(that is, gains or losses). The payable or receivable is settled by check, draft, or wire transfer before the market opens on the next business day. In addition, the clearing organization may call on the clearing member for additional original margin. The margin and option premiums deposited at the clearing organizations are kept under the control of these clearing organizations as a guarantee against defaults.

2.100 *Special Commodities Records.* The Commodity Futures Trading Commission (CFTC), which regulates activities in futures and options on futures, requires full, complete, and systematic records of all transactions relating to the business. At a minimum, those records include the following:

- Monthly computation of minimum financial requirements
- Daily computation of funds segregated for customers trading on U.S. futures exchanges and reservation of funds for U.S. customers trading on non-U.S. futures exchanges
- Records of all charges and credits in each customer's account and all the following:
 - Futures transactions executed for such accounts (including the date, price, quantity, market, commodity, and futures month)
 - Options on futures transactions executed for such accounts (including the date, an indication of whether the transaction involved a put or call, the expiration date, the quantity, the underlying contract for future delivery or underlying physical strike price, and details of the purchase price of the option, including premium, mark-up, commission, and fees).
- Details of securities and property received as margin
- Confirmations to each customer of futures and options transactions executed on the customer's behalf
- Purchase and sale statements to each customer for offsetting transactions
- Monthly statements to customers, specifying open positions and trade prices, net unrealized profits or losses in all open futures contracts, the market value of all open options on futures contracts, the ending ledger balance reflected in the customer's account, and details of any securities and property deposited by the customer as margin
- The customer name and address file indicating the principal occupation or business of the customer, signature cards, and risk disclosure statements
- Time-stamped order and execution tickets that include the account identification and order number
- Details of investments of customer funds
- A trade register that is a record for each business day, detailing all futures transactions and options on futures transactions executed on that day
- The monthly point balance, which accrues, or brings to the official closing price or settlement price fixed by the clearing organization, all open contracts of customers as of the last business day of each month or of any regular monthly date selected (However, while CFTC

regulations only require a monthly point balance, a firm with strong internal control would be performing this balancing on a daily basis.)

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

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

Forward Transactions

2.103 Forward transactions (forwards) are defined as existing trade commitments with settlement dates subsequent to regular-way trades (see paragraph 7.15). They may have a time differential of up to one year or more, and are thus traded on a delayed delivery or forward basis. These transactions are normally recorded on memo records (such as a pending or when-issued file), which are confirmed on a regular basis similar to other customer positions that have settled. The accounting for those forward transactions is to recognize the gain or loss on a current basis (that is, by valuing the individual transaction on a current basis). See the "Derivatives" section in Chapter 7 of this Guide for a discussion of FASB Statement No. 133, as amended, which establishes the accounting and reporting standards for derivative instruments and for hedging activities.

Municipal Securities

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

2.105 However, there are certain factors that make the municipal securities market unique. The most significant are the following:

- Municipal securities, other than new issues, settle trade for trade rather than CNS because the Municipal Securities Rulemaking Board (MSRB) prohibits partial settlements.
- MSRB rules limit the buy-in period for aged fails-to-receive to ninety business days without full cooperation with the contra party. If a buy-in has not been completed within that time, the contra broker-dealer cannot be held liable for any losses incurred. (This rule is currently being reevaluated by a Bond Market Association subcommittee.)
- Many municipal securities are not depository-eligible and, therefore, require physical settlements.
- Because of the tax-exempt status of municipal securities, they are generally not sold short and are not actively loaned or borrowed.

International Securities

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

- There are custody issues related to the receipt and delivery of securities corresponding to transactions, the collection and payment of dividends and interest, information gathering, and processing with regard to corporate actions. Foreign custody agents must qualify under SEC rule 17f-4, governing the eligibility of depositories.
- Custody requirements vary by country. Settlement cycles, as well as holiday schedules, are usually different. Other than in the United States, the exchange of shares for money seldom takes place simultaneously. In some clearing environments, the actual delivery of shares takes place more than twenty-four hours before payment. Therefore, counterparty risk and the process for choosing counterparties are important factors.
- The means of settling transactions in different countries can be dissimilar. Depending on the marketplace, book shares, physical shares (both registered and bearer), issuers' receipts, or transfer agent receipts may be the norm for transfer of ownership.
- Trading in offshore markets may involve the use of corresponding foreign exchange (FX) transactions to convert into the local currency of the foreign market. Such an FX transaction is another contract with its own risks and liabilities.
- Each country has its own unique rules relating to certain exception-type transactions. The issues may be whether short sales are allowed in the trading environment, if a stock loan is a business in that market, and what the regulatory issues relating to contract closeouts are.
- Tax and regulatory issues within a foreign market are another of the considerations to review. Issues relating to the withholding of taxes, principal and income repatriation, and proper registrations are important within that market. The U.S. rules as they relate to a U.S. broker-dealer transacting business in the international marketplace are also a variable that affects business. Aged foreign fails are treated differently from domestic fails with respect to net capital charges and buy-ins (see SEC rules 15c3-1 and 15c3-3).
- Cultural differences, although not a quantitative concept, can at times be a factor in doing business internationally. Issues such as language barriers, differences in work habits, and time-zone differences should be considered.

Options on Securities

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

purchase and sales blotter and a separate position record for all option transactions for itself and its customers or market makers. See paragraphs 2.13, 2.23, and 2.28 for discussions of amendments to Rules 17a-3 and 17a-4.

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

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

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

2.110 The OCC issues a daily position report, which lists all option activity and ending positions for all accounts carried by the OCC member broker-dealer and the net daily pay or collect amount due to or from the OCC. The OCC also issues a margin report, which shows the OCC margin requirement on the aggregate short option positions and exercised contracts for each account carried by the OCC member broker-dealer. Required margin may be paid by cash, check, government securities, common stocks with a market value as specified by the rules, or an irrevocable letter of credit issued by an OCC-approved bank or trust company.

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

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

Reconciliation and Balancing

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

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

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

2.116 When a security difference is discovered, it should be recorded in a security difference account (a suspense account) pending research concerning the reason for the difference. When the difference is resolved, entries are made clearing the difference position from the stock record. If a short difference is not resolved, SEC rule 15c3-3 requires the broker-dealer to buy-in the shortages. Subject to legal interpretation concerning ownership, the overages may be sold.

Custody[†]

2.117 Customers' fully paid and excess-margin securities may be kept at a depository (see the following section, "Possession or Control") or in a vault on

[†] Recently, regulators have become concerned about proxy over-voting. Over-voting occurs when a broker-dealer or its proxy service provider sends out and processes to the issuer or its agent more votes than should be allowed. The processes and procedures by which the shares of beneficial owners are to be voted by member firms are governed by NYSE Rule 452, *Giving Proxies by Member Organization*. In November 2004, the NYSE issued Information Memo 04-58, *Supervision of Proxy Activities and Over-Voting*, to address issues uncovered during examinations of member organizations' proxy departments involving an apparent systemic over-voting of proxies and a general lack of effective supervision. According to Information Memo 04-58, such problems noted relate to:

- Failing to properly account for firm and customer short positions when calculating the firm's long position
- Incorrectly including shares which had been lent in the calculation of the firm's position
- Failing to correctly calculate the long position, then also failing to utilize the proxy service agency's over-voting reports

The SIA set up the Ad-Hoc Committee on Proxy Over-Reporting to work with the NYSE to establish a best practice for proxy processing. Readers should be alert to further developments on this issue.

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

Possession or Control

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

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

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

2.120 The ownership of securities that must be reduced to possession or control is usually indicated by means of additional columns or codes in the securities record. Instructions for the segregation or release from segregation of securities are issued by the margin department, frequently through an automated system. These instructions are processed into the broker-dealer's stock record, and total customer segregation requirements are compared with the total quantity of specific securities currently in possession or control. This comparison generates a report to the cashier's department indicating, by issue, the number of shares pending that must be placed in segregation by the cashier or the number of shares in excess of requirements that may be removed from segregation by the cashier. The cashier's department carries out the instructions generated by this comparison, which is produced on a daily basis. This system (commonly known as bulk segregation) does not relate certificates to specific customers; as an alternative, some firms may use specific identification for determining their segregation requirements.

2.121 Securities pending safekeeping or segregation (securities designated to be placed in safekeeping or segregation) may be fail-to-receive items,

transfer items, out on loan to another broker, or collateral for bank loans. Rule 15c3-3 limits the length of time during which securities can remain in those locations before the broker-dealer must take action to bring the securities into possession and control.

Securities Transfer

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

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

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

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

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

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

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

Dividends, Interest, and Reorganization

Dividends and Interest

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

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

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

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

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

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

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

2.134 The dividend department maintains a record of securities that the broker-dealer fails to receive or deliver on the record date. Securities received or delivered against fails that were open on the record date and that are in

the name of the delivering broker should be accompanied by due bills. A due bill is an official authorization allowing the purchasing broker-dealer to make a legal claim on the selling broker-dealer for a future distribution to which it is entitled. For cash dividends or interest payments, this typically takes the form of a postdated check. It is usually the responsibility of the dividend department to collect or authorize payments for transactions of this nature. Broker-dealers should maintain records for each security by individual declaration date and should not net dividends or interest either by security or between dates.

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

Reorganization

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

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

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

2.139 The reorganization department is responsible for processing securities involving corporate reorganizations. The responsibilities include—

- Executing corporate calls for redemption of issues in the custody of the brokerage firm.
- Converting securities into common stock on request of their underlying owner.
- Exchanging one class of security for another class of the same issuer, pursuant to a reorganization of the corporation.
- Exchanging one company's securities for another company's securities or money, pursuant to a merger or acquisition.
- Subscribing for new shares in a company, pursuant to a rights offering.
- Transmitting securities to an intended purchaser under terms of a tender offer on specific written instructions from its beneficial owner.
- Allocating results to customer accounts on partial tenders.

2.140 *Recording Customer or Proprietary Reorganization Transactions.* On the effective date of the reorganization, the original security is removed

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

Collateralized Financing Stock Loan and Stock Borrow

2.141 Securities not available to be delivered on the settlement date may be borrowed. A stock borrow occurs when a broker-dealer needs a security to deliver against a settling transaction, such as a short sale. A short sale is the sale of a security not owned by the firm or a customer. Short sales are often made in anticipation of a market decline or as part of a trading or hedging strategy.⁵ In addition, a broker-dealer may be involved in a finder's business, whereby securities are borrowed to relend to another broker-dealer, thus allowing the broker-dealer to earn a spread on the transaction. Broker-dealers may also engage in equity securities borrowed transactions solely for financing the positions of another broker-dealer where the equity securities are initially borrowed without a "permitted purpose" pursuant to Regulation T Section 220.10(a) and placed in a box location. These transactions, which are referred to as "non-purpose borrows," have regulatory implications which need to be considered in the computation of net capital.⁶

2.142 In general, broker-dealers borrow securities to deliver them to another broker-dealer or to a customer. Should the cashiering department need to borrow securities, it instructs the stock loan department to borrow them. The borrowing broker-dealer is required to deposit cash or other collateral, which may be in the form of securities issued or guaranteed by the United States or its agencies, certain certificates of deposit or bankers' acceptances, or irrevocable letters of credit. When the borrowing broker-dealer deposits cash, it receives an interest-like rebate on the amount that was exchanged for the securities. This rebate is negotiated, with the rate usually established by the lender and agreed to by the borrower. Should a security be difficult to obtain, a lower rebate would be acceptable. The borrowing broker-dealer records the transaction as a long on the stock record and as an asset in the general ledger (receivable from the lending broker). The lending broker records a short position on the stock record and a liability in the general ledger. FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, provides specific criteria for determining whether a securities lending transaction is to be accounted for as a sale or as a secured borrowing (see Chapter 7, "Accounting Standards" for a discussion of secured borrowing) and provides an illustration of the latter.⁷

2.143 For each security borrow or loan position, information may be prepared and retained in the cashiering department, to be used as the basis for an

⁵ Hedge accounting is permitted only if the requirements of FASB Statement No. 133, as amended, are met.

⁶ Refer to SEC rule 15c3-1(c)(2)(iv)(B)/093 interpretation at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE=NASDW_013166 for additional guidance.

⁷ FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, among other matters, provides guidance for recognition and reclassification of collateral and for disclosures relating to securitization transactions and collateral.

out-of-loaned or out-of-borrowed entry and also in the comparison of cashiering department records with the stock record and general ledger for control purposes. The cashiering department records contain such details of securities borrowed and loaned transactions as the following:

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

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

Bank Loan Financing

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

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

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

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

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

Reverse Repos and Repos

2.149 Reverse repos are similar to securities-borrowed transactions except that reverse repos are generally executed with government and government-agency securities. Securities are usually borrowed to make deliveries on short sales, whereas reverse repos are frequently related to investment activities as well as meeting delivery requirements.⁸

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

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

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

2.153 The rights of parties involved in a repo or reverse repo transaction depend on the particular terms and conditions of the transactions that are documented in a written agreement or transaction confirmation. Most firms use a standard agreement developed by the Bond Market Association.⁹ The documentation diminishes uncertainties for such transactions. Written agreements should describe the transaction, the terms and conditions of the contract, and the rights of the parties, including the following:

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

⁸ Reverse repurchase agreements discussed in this Audit and Accounting Guide are usually referred to as *repurchase agreements* by the investment company and banking industries.

⁹ The Bond Market Association was formerly the Public Securities Association.

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

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

Regulatory

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

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

2.157 The records of a broker-dealer are generally required to be maintained for two years in a readily accessible place at the broker-dealer's principal place of business. Thereafter, the length of time the broker-dealer is required to maintain the records varies. Basic accounting records must be kept for six years. Records relating to the terms and conditions of opening and maintaining an account must be kept at least six years after closing the account. Other records (such as corporate charters, partnership agreements, minute books, and stock certificate books) must be kept for the life of the broker-dealer. Certain states and other authorities may have additional requirements for keeping books and records.

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

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

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

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

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

Tax Information Reporting

2.163 A broker-dealer is required to file information notices with the IRS for certain customer transactions and to also send such notices to the customer. Examples of the more common notices and of the information they provide include the following:

- *1099-B (Broker Transactions)*. The gross proceeds from the sales of customer transactions conducted by the broker-dealer during the year
- *1099-INT (Interest)*. The amount of interest received by the customer from securities held by the broker-dealer during the year
- *1099-DIV (Dividends)*. The amount of dividends received by the customer from equity securities held by the broker-dealer during the year
- *1099-OID (Original Issue Discounts)*. The amount of interest accreted on original issue discount securities (and any interest received on original issue discount securities) held by the broker-dealer during the year
- *1099-R (Retirement Funds)*. The amounts withdrawn during the year from an individual retirement account (IRA) or a pension account that is held at the broker-dealer's firm (The broker-dealer must also provide other information about IRA arrangements on form 5498.)
- *1099-MISC (Miscellaneous)*. The amount of dividends earned by the customer but not received because the security was placed by the broker-dealer in a stock loan at the customer's request

2.164 The IRS generally matches information notices filed by the broker-dealer to its database to determine whether the payee's name and taxpayer

identification number (TIN) correspond to its records. If there is a mismatch, the IRS notifies the broker-dealer (payor) of this fact. The payor is then required to send a letter to the payee informing him or her of the mismatch and request a Form W-9 within thirty calendar days of the date of the notification from the IRS. If the payee does not return this W-9, all future reportable payments must be subjected to backup withholding. If a payor does not withhold when required to do so, the payor becomes responsible for the tax.

2.165 The IRS has a 2:3 rule, which provides that a payor receiving two notices in any three-year period reflecting that a payee has provided an incorrect TIN must begin backup withholding and must continue to do backup withholding until notified by either the IRS or the Social Security Administration to stop. Once again, failure to withhold when required to do so will result in the payor being held responsible for the tax.

2.166 The IRS requires broker-dealers to file Form 4879, *Currency Transaction Report*, for customer deposits, withdrawals, exchanges of currency, or other payments or transfers by, through, or to the broker-dealer if they involve a transaction in currency of more than \$10,000.

Illustrative Stock Record Entries

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

1. Customer A buys one hundred shares of ABC at \$20.00 per share. Note that the Entry assumes the securities are not received on the settlement date.

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

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

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

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

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

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

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

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

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

6. Customer B sold two hundred shares of DEF at \$30.00 per share. Note that the entry assumes the securities were in transfer and therefore not delivered on the settlement date.

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

7. DEF was delivered through DTC.

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

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

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

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

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

10. The firm decides to buy five thousand shares of GHI at \$2.00 a share for its inventory.

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

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

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

Chapter 3

Regulatory Considerations

3.01 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). Such requirements for broker-dealers that are also commodities brokers, known as futures commission merchants (FCMs), are regulated by Regulation 1.16 of the Commodity Exchange Act, while the requirements for registered broker-dealers in U.S. government securities are regulated by section 405.2 of the regulations pursuant to section 15C of the Exchange Act. Those rules are listed at the end of this chapter. Before undertaking the audit of a broker-dealer in securities, the auditor should read the applicable rules and have an understanding of the prescribed scope of the audit and the related reporting requirements.

Applicable Rules

3.02 In 2004, the SEC passed rules creating a regulatory framework for certain investment bank holding companies with broker-dealers that meet capital and other requirements to be supervised by the SEC as a "consolidated supervised entity" (CSE). These rules created a two-tier regulatory system for broker-dealers. The following discussion focuses on the rules and regulations for broker-dealers not subject to the special provisions of the CSE regulatory framework. Where applicable, the special provisions pertaining to CSEs are discussed.

3.03 The Securities and Exchange Commission's (SEC's) rules require the auditor to be designated by the broker-dealer, in writing, to the SEC and to the examining authority, such as the National Association of Securities (NASD) or a securities exchange, of which the broker-dealer is a member. The primary rules under the Exchange Act that are applicable to the audits of broker-dealers in securities are as follows:¹

- Rules 8c-1 and 15c2-1, "Hypothecation of Customers' Securities"
- Rule 15a-6, "Exemption of Certain Foreign Brokers or Dealers"
- Rule 15c3-1, "Net Capital Requirements for Brokers or Dealers"
- Rule 15c3-3, "Customer Protection: Reserves and Custody of Securities"
- Rule 17a-3, "Records to Be Made by Certain Exchange Members, Brokers, and Dealers"

¹ Paragraphs 3.140 and 3.141 of this Guide provide additional discussion of rules adopted under the Exchange Act for over-the-counter (OTC) derivatives dealers who register with the SEC under a limited regulatory structure rather than under the usual broker-dealer regulatory regime of Exchange Act Section 15(b).

- Rule 17a-4, "Records to Be Preserved by Certain Exchange Members, Brokers, and Dealers"
- Rule 17a-5, "Reports to Be Made by Certain Brokers and Dealers"
- Rule 17a-11, "Supplemental Current Financial and Operational Reports to Be Made by Certain Exchange Members, Brokers, and Dealers"
- Rule 17a-13, "Quarterly Security Counts to Be Made by Certain Exchange Members, Brokers, and Dealers"
- Rules 17h-1T and 17h-2T, "Final Temporary Risk Assessment Rules"
- Federal Reserve Regulation T (Regulation T) of the Board of Governors of the Federal Reserve System
- Commodity Futures Trading Commission (CFTC) Regulations 1.20-1.30 and 30.7, "Segregation of Customers' Funds and Foreign Futures" and "Foreign Options Customers' Secured Amount"

3.04 A general familiarity with the rules of the various exchanges, the Treasury Department and the CFTC if the broker-dealer is a government securities dealer or an FCM, and the NASD will be helpful to the auditor in understanding the relationships among the rules.

Interpretations of Rules

3.05 Published interpretations of certain rules of the regulatory bodies may be found in the following reference materials:

- Financial and Operational Combined Uniform Single (FOCUS) report forms and their general instructions
- SEC interpretative releases (Exchange Act series) and published interpretative and no action letters
- Treasury Department Interpretations
- CFTC Interpretations and Advisories
- *Interpretation Handbook* of the New York Stock Exchange (NYSE), which relates to the uniform net capital, customer protection, and related rules (The NYSE began issuing information memos and interpretation memos in 1976; educational circulars that were issued before 1976 continue in effect unless the circular has been superseded.)
- *NASD Guide to Rule Interpretations*, *NASD Manual*, and *NASD Interpretations*
- Interpretative instructions distributed to their respective memberships by other self-regulatory organizations
- Published securities services (Commerce Clearing House, Prentice-Hall, and *Securities Regulation and Law Report*)

3.06 The auditor should inquire whether the broker-dealer has requested and received specific interpretations from any regulatory agency since the prior audit. Appropriate consideration should be given to their effect, if any, on the financial statements of the broker-dealer being audited.

Explanation of Significant Rules

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

3.07 The SEC adopted rule 15c3-3 under the Exchange Act to accomplish the following objectives (see paragraph 3.35 for a discussion of the types of broker-dealers that are exempt from rule 15c3-3):

- To ensure that customers' assets held by a broker-dealer are properly safeguarded
- To require the broker-dealer to obtain prompt possession or control of customers' fully paid and excess-margin securities
- To separate firm and customer-related business
- To require a broker-dealer to make daily determinations of security locations and to prepare periodic computations of amounts required to be on deposit in a special bank account for customers
- To motivate the securities industry to process its securities transactions as expeditiously as possible by penalizing a broker-dealer if a security is in an unacceptable location for too long a period
- To protect customer assets in the event of the liquidation of insolvent broker-dealers

3.08 Those objectives are accomplished through the two main sections of the rule, which provide for (a) the requirement that the broker-dealer obtain excess-margin securities and (b) the reserve formula computation and the maintenance of a "Special Reserve Bank Account for the Exclusive Benefit of Customers."

3.09 NYSE Interpretation Memo 98-10 extends the requirement to perform a Customer Reserve Computation with respect to proprietary accounts of introducing brokers (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.

3.10 The restrictions on the use of customers' funds and securities and the requirement that securities be brought promptly under physical possession or control are designed to protect customer assets in the event that a broker-dealer must be liquidated. Rule 15c3-3 also acts as a control over the unwarranted expansion of a broker-dealer's business by prohibiting the use of customers' funds

* Recently regulators focused on cash sweep account programs under which customer funds are transferred out of a broker-dealer to an interest bearing account for the customer at a bank often affiliated with the broker-dealer. In February 2005, the NYSE issued Information Memo No. 05-11, *Customer Account Sweeps to Banks*, which addresses issues involving the adoption of new cash sweep programs and provides procedures designed to safeguard investor interests.

NYSE member organizations that have sweep arrangements whereby customer funds leave the broker-dealer and are held for any period of time by a party other than the bank must address critical issues relating to customer protection and net capital requirements. Customer credit balances that leave the broker-dealer and are not immediately reinvested in an FDIC protected account may be deemed to be included as a credit in the reserve formula. In addition, any receivable on the broker-dealer's books resulting from a sweep may be deemed to be a non-allowable asset. Readers should refer to Information Memo 05-11 for more information, and should be alert to further developments.

and customer-derived funds in other aspects of the broker-dealer's business such as for underwriting, trading, and overhead expenses.

3.11 SEC rule 15c3-3 offers further customer protection by requiring, under certain circumstances, an increase in the amount of the cash reserve under the formula to the degree that a broker-dealer fails to promptly obtain possession or control of customers' fully paid securities or loses control of its records. One of the consequences of faulty records is an increase, with regard to both quantity and aging, in such items as securities in transfer, security count differences, and securities in suspense accounts. As these items increase, the amount of the customer reserve requirement also increases. The rule also encourages the settlement of securities on a timely basis and the reduction of fails.

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

- Brokers or dealers
- Municipal securities dealer, or a government securities broker or government securities dealer
- General partner, managing member of a limited liability company or director or principal officer of the broker or dealer
- A counterparty who has delivered collateral to an OTC derivatives dealer who registers with the SEC under a limited regulatory structure, as discussed in paragraph 3.140 of this Guide, pursuant to a transaction in an eligible OTC derivative instrument or pursuant to the OTC derivatives dealer's cash management securities activities or ancillary portfolio management securities activities, and who has received certain prominent written notices from the OTC derivatives dealer
- Any person, to the extent they have a claim on property or funds which by contract, agreement, or law are part of the capital or subordinated debt of the broker-dealer

3.13 The following broker-dealer accounts are considered customer accounts:

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

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

[†] See footnote † to the Custody section in Chapter 2 starting in paragraph 2.117.

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

3.16 There are two exceptions to the possession or control requirements that are contained in SEC rule 15c3-3:

- a. Temporary business lags between the time when a security is required to be in the possession or control of the broker-dealer and the time it is taken into physical possession or control are one exception, provided the broker-dealer takes timely steps in good faith to establish prompt physical possession or control.
- b. The broker-dealer borrows from its customers fully paid-for or excess-margin securities that it is required to have in possession or control and enters into a written securities-borrowing agreement with the customer that sets forth in a separate schedule the basis for compensation for the securities borrowing and the rights or liabilities of the parties and provides that the customer is given a schedule of securities borrowed at the time of the borrowing. The agreement must also specify that upon the execution of the agreement or, if the borrowing occurs subsequent to the execution of the agreement, by the close of the business day of the securities borrowing, the broker-dealer provide the customer with certain qualified collateral and must mark the securities borrowed to the market not less than daily. In the event that the market value of all the outstanding securities borrowed at the close of trading at the end of the business day exceeds 100 percent of the collateral then held by the customer, the borrowing broker-dealer must provide additional collateral to the customer by the close of the next business day as necessary to equal—together with the collateral then held by the customer—not less than 100 percent of the market value of the securities borrowed. The agreement must also contain a prominent notice that the provisions of the Securities Investor Protection Act of 1970 may not protect the customer with respect to the securities loaned.

3.17 *Possession or Control Requirements.*[†] The broker-dealer must perform the following procedures daily to comply with the rule's possession or control requirements:

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

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

[†] See footnote † in paragraph 3.14.

3.19 For a margin account, the broker-dealer must determine the customer's net debit balance by adding the market value of securities sold short to the net debit money balance in the account and by multiplying the adjusted net debit balance by 140 percent. The resulting securities value is generally available for use by the broker-dealer. Securities having a market value in excess of 140 percent of the adjusted net debit balance must be segregated.

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

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

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

3.23 The broker-dealer must determine, by customer, the amount of each security that must be segregated. The broker-dealer must then determine the total securities to be segregated. Securities in the following locations are considered to be under the control of the broker-dealer:

- A qualified account at a clearing corporation or depository
- A qualified account at a bank (as defined in section 3(a)(6) of the Exchange Act), provided the delivery of such securities does not require payment and there is written acknowledgment stating that the securities are lien-free
- In transfer for under forty calendar days or confirmed as being in transfer (The securities must be bona fide items of transfer.)
- The custody of a qualified foreign depository, foreign clearing agency, or foreign custodian bank approved by the SEC
- In transit for five business days or less between the offices of a broker-dealer (for example, between the main and branch offices)
- A special omnibus account carried for the account of any customer by another broker-dealer and carried in the name of the broker-dealer in compliance with Regulation T (Such securities are considered in control to the extent that the broker-dealer has instructed the carrying broker-dealer to maintain physical possession or control of them free of any charge, any lien, or any other claim in favor of the carrying firm.)

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

- Securities collateralizing bank loans
- Securities loaned to other broker-dealers
- Securities failed to receive for more than thirty calendar days

- Stock dividend receivables, stock splits or receivables for more than forty-five calendar days

3.25 *Special Reserve Bank Account for the Exclusive Benefit of Customers.* As required by SEC rule 15c3-3, every broker-dealer, unless otherwise exempt, must maintain a "Special Reserve Bank Account for the Exclusive Benefit of Customers" separate from all other bank accounts of the broker-dealer. In the reserve bank account, the broker-dealer must at all times maintain cash and qualified securities in an amount not less than the amount computed under the rule's reserve formula.

3.26 The basic concept involved in the calculation of the reserve formula is that a broker-dealer will have to maintain deposits of cash or qualified securities on deposit in the reserve bank account to the extent that customer-related credits exceed customer-related debits. If the broker-dealer's customer-related debits exceed the customer-related credits, no deposit is required.

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

3.28 In addition, SEC rule 15c3-3 stipulates the designated times for performing the computations as follows.

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

3.29 The auditor should review the broker-dealer's practices, procedures, and controls covered by this rule and should perform those tests that the auditor considers necessary to be satisfied that the procedures and controls, including the written documentation, provide reasonable assurance that the broker-dealer is in compliance with the rule.

3.30 *Broker-Dealers Exempt From SEC Rule 15c3-3.* Certain broker-dealers adhere to the exemptive provisions of SEC rule 15c3-3. In doing so, the broker-dealer is not required to comply with the remaining provisions of that rule, such as computations of amounts required to be on deposit in the "Special Reserve Bank Account for the Exclusive Benefits of Its Customers," possession or control requirements, and so forth. The detailed requirements to be met in order to qualify for this exemption are outlined in SEC rule 15c3-3 and need to be considered in connection with the rule in its entirety.

3.31 Regulators have consistently taken a stringent enforcement approach to Rule 15c3-3 without regard to materiality. Their approach has probably occurred because of the rule's previously stated objectives of safeguarding customer assets, obtaining prompt possession or control, and separating firm from customer-related business.

3.32 Stringent enforcement has included significant fines, public censure, and the banning of officers from the security business for periods of time. Accordingly, in making the required SEC Rule 15c3-3 deposit, industry practice, as well as good business sense, has a firm often add an additional amount or "cushion" to the amount determined for the weekly or monthly reserve deposit.

3.33 Any deficiency, no matter how small, may cause significant adverse regulatory penalties.

3.34 Likewise, the regulators have taken a stringent approach to enforcing the spirit of the rule as well as its letter. Accordingly, the regulators will closely scrutinize any apparent differences between procedures occurring at either week's end or month's end (that is, borrowing unsecured at determination date) and those procedures or business practices occurring on a day-to-day basis (bank loans secured by customer securities during the remainder of the week).

3.35 In auditing the financial statements of a broker-dealer that is claiming exemption from SEC Rule 15c3-3, the auditor should determine under which specific section of the rule the exemption is being claimed and what controls and procedures are in place to ensure compliance with that section. The independent auditor should ascertain that the conditions of the exemption were being complied with as of the audit date and that no facts came to its attention to indicate that the exemption had not been complied with during the period since the prior audit. For example, a nonclearing broker-dealer (fully disclosed) does not carry customers' accounts on its books and therefore would not have to comply with the reserve requirements as stated in SEC Rule 15c3-3. Therefore, no computations or review would be made, but the independent auditor should ascertain that there were indeed no customer accounts that were appearing (or should have appeared) on the books and records of this broker-dealer.

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

3.37 In reporting on a broker-dealer exempt from SEC Rule 15c3-3, the schedules entitled "Computation for Determination of Reserve Requirements Under Rule 15c3-3" and "Information for Possession or Control Requirements Under Rule 15c3-3" are not applicable. In lieu of those schedules, a statement should be included indicating the section under which exemption is claimed. With respect to the effect of the exemption on the "Independent Auditor's Supplementary Report on Internal Control," see Appendixes D and D-1 of this Audit and Accounting Guide (Guide).

SEC Rule 15c3-1, "The Uniform Net Capital Rule"†

3.38 SEC Rule 15c3-1, "Net Capital Requirements for Brokers or Dealers," also referred to as the "Uniform Net Capital Rule" and set out under the

† Please refer to footnote * immediately preceding paragraph 3.07 for a discussion of potential impact of cash sweep account programs on broker-dealer's compliance with net capital requirements.

Exchange Act, was enacted as one of the rules establishing minimum financial responsibility requirements for broker-dealers. The rule was adopted to create a uniform capital requirement for all registered broker-dealers and to ensure the liquidity of broker-dealers.

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

- The broker-dealer's capital (equity plus qualified subordinated indebtedness) is reduced to give effect to the elements of market, credit, or operational risk inherent in the business in which the broker-dealer currently is engaged.
- The minimum capital that the broker-dealer is required to maintain pursuant to SEC Rule 15c3-1(a)(1)(iii) is established on the basis of the greater of either: (a) the level of aggregate indebtedness (that is, the broker-dealer's current liabilities less certain exceptions) the broker-dealer maintains, (b) the level of customer-related receivables (aggregate debit items) computed pursuant to SEC Rule 15c3-3 (the alternative method), or (c) if the broker-dealer is also registered as an FCM, the greater of:
 - (i) the selected SEC Rule 15c3-1 method described above or 4 percent of the amount required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the customer's account), or
 - (ii) the minimum financial requirements for futures commission merchants, including the risk-based requirement, and introducing brokers pursuant to CFTC Regulation 1.17(a)(1)(i)

3.40 In each case, the level of capital is established to ensure that, in the event of a liquidation, the broker-dealer is maintaining adequate levels of capital to ensure the payment of its obligations to customers and other broker-dealers.

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

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

3.43 The SEC requires all registered broker-dealers to calculate net capital on a periodic basis and to maintain compliance with the rule at all times. Net capital is the broker-dealer's net worth adjusted for illiquid (nonallowable) assets, certain operational capital charges, and potential adverse fluctuations in the value of securities inventory (haircuts). The purpose of the net capital computation is to determine that the broker-dealer's net liquid assets (minimum capital base) are adequate in the event of sudden adverse business conditions.

3.44 The minimum capital base is designed to protect customers, creditors, and other broker-dealers. There are basically two parts to the net capital computation: (a) determination of net capital and (b) comparison with percentage requirements.

3.45 As stated before, net capital is calculated and analyzed either as a percentage of aggregate indebtedness (the basic method), Rule 15c3-3 aggregate debit items (the alternative method), or if the broker-dealer is also registered as an FCM, the greater of the SEC requirement or 4 percent of the amount required to be segregated for commodities customers as defined in the CFTC regulations.

3.46 Under the aggregate indebtedness method, a broker-dealer is not permitted to allow its aggregate indebtedness to exceed fifteen times its adjusted net capital. If the ratio of aggregate indebtedness to adjusted net capital exceeds—

- Fifteen to one, the broker-dealer is prohibited from engaging in any securities transactions.
- Twelve to one, the broker-dealer may be required to reduce its business.
- Ten to one, the broker-dealer may be prohibited from expanding its business.

3.47 As set forth in SEC Rule 15c3-1, a broker-dealer may elect to compute its net capital requirements under the alternative method.

3.48 The minimum net capital percentage required under the alternative method is 2 percent of aggregate debit items. As a result, this method requires a broker-dealer to maintain minimum net capital equal to the greater of a minimum amount or 2-percent aggregate debit balances included in the reserve formula.

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

3.50 *Computation of Net Capital.* The net capital of a broker-dealer is equal to its net worth adjusted by certain additions and deductions. The additions include—

- Certain liabilities, approved by the examining authorities, that have been subordinated to the claims of general creditors. The extent to which these liabilities may be included in capital is subject to limitations. Standardized subordination, secured demand note, and secured demand note collateral agreements are available from the NASD, and all executed agreements must be approved by the broker-dealer's

designated self-regulatory organization before they qualify for capital purposes. A subordination agreement is required to—

- Be written.
- Have a minimum term of one year.
- Be for a specific dollar amount.
- Effectively subordinate the lender's right to prior payment of all claims of present and future creditors.
- Give the broker-dealer the right to deposit any cash proceeds in its own name in any bank, as well as the right to pledge or hypothecate securities without notice.
- Meet certain prepayment restrictions.
- Suspend the repayment or maturity obligation if, after giving effect to the obligation, the aggregate indebtedness of the broker-dealer would exceed 1,200 percent of its net capital or its net capital would be less than 6 percent of aggregate debits if the alternative capital method were used.

For a further discussion, see the specific requirements contained in the debt-equity requirements of Rule 15c3-1 and Appendix D to SEC Rule 15c3-1.

- Certain discretionary liabilities. A noncontractual bonus accrual is the most common type of discretionary liability.
- Deferred income tax liabilities resulting from the recognition for tax purposes of unrealized income or appreciation related to long inventory or investment positions or to assets that are non-allowable for net capital; and deferred income tax benefits resulting from the recognition for tax purposes of unrealized losses or depreciation related to long inventory or investment positions, but only up to the extent of recognized income tax liabilities. Please see the specific requirements contained in Rule 15c3-1 and related interpretations.

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

- a. *Nonallowable assets.* These are certain debit amounts recorded in the books of the broker-dealer that do not meet liquidity tests or have been defined as nonallowable by Rule 15c3-1. In general, non-allowable assets are assets not readily convertible into cash. Examples of the most frequently encountered nonallowable assets are fixed assets, securities that are not readily marketable, deficits in certain customer accounts, good-faith deposits, prepaid expenses, exchange memberships, intangibles such as goodwill and organizational expenses, and unsecured receivables net of any reserves. Broker-dealers that introduce their proprietary accounts (PAIB accounts) on a fully disclosed basis to their clearing broker-dealers must treat these assets as non-allowable unless the introducing broker and its clearing broker agree in writing to perform a computation for PAIB assets in accordance with the customer reserve computation set forth in Rule 15c3-3 (customer reserve formula). Refer to NYSE Interpretation Memo 98-10 and the no action letter attached thereto.

- b. *Other deductions and charges.* In general, these items are not recorded in the books for money or they represent a percentage of an amount recorded in the general ledger. These items include operational charges for bookkeeping inefficiencies (for example, aged fails and securities count differences).
- c. *Haircuts on proprietary positions and commitments.* Haircuts are percentage deductions that are designed to take into account portfolio risk and market risk on proprietary positions and commitments. They apply to marketable securities only.²

3.52 *Computation of Aggregate Indebtedness.* SEC Rule 15c3-1 states that aggregate indebtedness is made up of the total money liabilities of a broker-dealer arising in connection with any transaction whatsoever, and includes, among other things, money borrowed, money payable against securities loaned and securities failed to receive, the market value of securities borrowed to the extent to which no equivalent value is paid or credited, customers' and noncustomers' free credit balances, credit balances in customers' and noncustomers' accounts having short positions in securities, equities in customers' and noncustomers' future commodities accounts, and credit balances in customers' and noncustomers' commodities accounts but excluding certain items.

3.53 In the event that compliance has not been met or the controls and procedures over the computation of net capital are deemed inadequate, the auditor should immediately consider the notification requirements under SEC rules 17a-5 and 17a-11 pertaining to material inadequacies.

3.54 *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities.* In June 2004, the SEC adopted rule amendments under the Securities Exchange Act of 1934 that establish a voluntary, alternative method of computing deductions to net capital for certain broker-dealers. This alternative method permits a broker-dealer to use mathematical models to calculate net capital requirements for market and derivatives-related credit risk. A broker-dealer using the alternative method of computing net capital is subject to enhanced net capital, early warning, record-keeping, reporting, and certain other requirements, and must implement and document an internal risk management system. Furthermore, as a condition to its use of the alternative method, a broker-dealer's ultimate holding company and affiliates (referred to collectively as a consolidated supervised entity, or "CSE") must consent to group-wide SEC supervision. This supervision would impose reporting (including reporting of a capital adequacy measurement consistent with the standards adopted by the Basel Committee on Banking Supervision), recordkeeping, and notification requirements on the ultimate holding company. The ultimate holding company (other than an "ultimate holding company that has a principal regulator") and its affiliates also would be subject to examination by the SEC. See SEC Release No. 34-49830 for more information on this rule.

3.55 *Expense-Sharing Agreements.* Many broker-dealers enter into what is generally referred to as an expense sharing agreement with their parent or an affiliated company. The parent or affiliate is usually not registered as a

² An OTC derivatives dealer who registers with the SEC under a limited regulatory structure, as discussed in paragraph 3.140 of this Guide, may apply to the SEC for authorization to compute capital charges for market and credit risk pursuant to Appendix F to Rule 15c3-1 in lieu of computing securities haircuts pursuant to Rule 15c3-1(c)(2)(vi).

broker-dealer, and accordingly, is unregulated. In certain instances, a parent or an affiliate has established a broker-dealer to conduct limited or specialized securities activities that are coincidental or tangential to the operations of the parent or affiliate. In other instances, the parent or affiliate will have limited operations and will conduct separate financial activities using funds obtained from the broker-dealer's operations. In either case, the broker-dealer and the parent or affiliate are likely to incur common costs, such as rent, and devise an arrangement to allocate or assign direct and/or general overhead costs between them and specify which party will settle the related obligations. Thus an arrangement will deal with both cost recognition and payment responsibility.

3.56 In interpretations related to its Rule 15c3-1, The Uniform Net Capital Rule, the SEC Division of Market Regulation staff have stated clearly that, for the purpose of computing net capital, broker-dealers are required to recognize costs on their books and records in accordance with generally accepted accounting principles. That is, costs need to be recognized as incurred and in amounts related to the broker/dealer's economic obligations. As regulatory financial reports submitted by broker-dealers seemed to indicate a number of deviations from this standard, the Division of Market Regulation staff issued an interpretative letter on July 11, 2003 addressing situations when another party "assumes responsibility for payment of a broker-dealer's expenses."

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

SEC Rule 17a-13, "Quarterly Security Counts"

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

- Physically examine and count all securities held.
- Account for all securities in transfer, in transit, pledged, loaned, borrowed, deposited, failed to receive and failed to deliver, subject to repurchase agreements (repos) or reverse repos, or otherwise subject to

the broker-dealer's control or direction but not in its physical possession, by examining and comparing the supporting detail records with the appropriate ledger control accounts.

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

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

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

3.61 If the auditing procedures include a 100-percent verification of all security positions, the broker-dealer may use this verification as one of the quarterly counts. In the event that the auditor performs only part of the procedures required by the rule, the broker-dealer must complete the count and verification procedures to the extent that they are not carried out by the independent auditor.

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

3.62 SEC rule 17a-3, "Records to Be Made by Certain Exchange Members, Brokers, and Dealers," requires parties to construct and keep current certain books and records. For a further discussion of this rule, refer to Chapter 2, "Broker-Dealer Functions, Books, and Records," of this Guide.

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

3.63 SEC rule 17a-4, "Records to Be Preserved by Certain Exchange Members, Brokers, and Dealers," establishes time requirements for the retention of the books and records constructed pursuant to rule 17a-3. (For a further discussion of this rule, refer to Chapter 2 of this Guide.)

Regulation T and Maintenance Margin[†]

3.64 Regulation T has been promulgated by the Board of Governors of the Federal Reserve System by authority of the Exchange Act. Regulation T

[†] See footnote † in paragraph 3.14.

establishes the rules and regulations applicable to the extension of credit to customers and to related transactions. For a customer to enter securities transactions, he or she must open either a cash account or a margin account.

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

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

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

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

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

3.70 The NYSE,¹¹ the NASD, and broker-dealers themselves may set margin requirements that are higher than those specified in Regulation T. There

¹¹ NYSE Rule 431, "Margin Requirements," generally prescribes minimum initial and maintenance margin requirements. On July 14, 2005, the SEC approved amendments to NYSE Rule 431 which permit the use of a prescribed risk-based margin methodology (portfolio margin), for certain specified products, as an alternative to the strategy-based margin requirements previously stipulated in NYSE Rule 431(a) through (f). This approval became effective immediately, beginning with a pilot period that will expire on July 31, 2007. For more information please refer to SEC Release No. 34-52031 and NYSE Information Memo No. 05-56. By separate orders, the SEC also approved a parallel rule filing by the Chicago Board Options Exchange (CBOE), and a related rule filing by the Options Clearing Corporation (OCC). See SEC Releases No. 34-52030 and No. 34-52032.

(continued)

is one major difference between these requirements and the requirements of Regulation T. Regulation T is an initial requirement. The NYSE and the NASD requirements are initial and maintenance requirements. This simply means that, unlike Regulation T, these requirements apply to the initial trades and to the position that is retained in the account. In addition, many broker-dealers maintain "house" margin requirements (both initial and maintenance) that are higher than those established by the NYSE and the NASD.

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

3.71 The CFMA (see paragraph 1.44 of this Guide) provided for the issuance of rules governing customer margin for transactions in security futures. Specifically, the CFMA directed the Federal Reserve Board to prescribe rules establishing initial and maintenance customer margin requirements. SEC Rules 400 through 406 and CFTC rules 41.42 through 41.49 were issued in August 2002 establishing margin requirements for security futures pursuant to joint authority delegated by the Federal Reserve Board.

SEC Rules 17h-1T and 17h-2T, "Final Temporary Risk Assessment Rules"

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

3.73 In June 2004, the SEC issued rule amendments and new rules under the Securities Exchange Act of 1934 that establish two separate voluntary regulatory frameworks for the SEC to supervise broker-dealers and their affiliates on a consolidated basis. These two rules, *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities (CSE)* (SEC Release No. 34-49830) and *Supervised Investment Bank Holding Companies (SIBHC)* (SEC Release No. 34-49831), among other things, amend Rules 17h-1T and 17h-2T to exempt from the risk assessment rules broker-dealers that are affiliated with an SIBHC and those broker-dealers that use the alternative method of computing net capital and are affiliated with ultimate holding companies that do not have principal regulators.

3.74 Determination of whether an affiliate or other associated person is a Material Associated Persons (MAP) requires consideration of the following:

(footnote continued)

Furthermore, on December 29, 2005, and on March 2, 2006, the NYSE filed with the SEC proposed amendments to NYSE Rule 431 that would expand the scope of products that are eligible for treatment as part of the SEC's approved Portfolio Margin Pilot Program. The March 2, 2006, rule proposal (SEC Release No. 34-53577) would also eliminate the requirement for a separate cross-margin account for margining eligible security products with eligible commodity products. The December 29, 2005, rule proposal was approved by the SEC on July 11, 2006 (see SEC Releases No. 34-54125 for more information). Also, on February 2, 2006, the CBOE filed with the SEC proposed rule changes to broaden its Rule 12.4, "Portfolio Margin and Cross-Margin for Index Options," to allow portfolio margining of listed equity options, narrow-based index options, and security futures, as well as certain OTC instruments (see SEC Releases No. 34-53576 for more information).

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

3.75 The information to be filed by each MAP on a quarterly basis on or with Form 17h and for which records must be maintained in a readily accessible place for three years includes the following:

- Financial information
- Firm inventory amounts
- Off-balance-sheet items
- Unsecured credit extensions
- Current debt
- Summaries of real estate activities

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

SEC Rule 17a-5, "Reports to Be Made by Certain Brokers and Dealers"

3.77 SEC Rule 17a-5 describes the objectives of an examination by independent auditors, which include obtaining reasonable assurance that material inadequacies existing at the audit date in the accounting system, control procedures,[#] and procedures for safeguarding securities would be disclosed. Rule 17a-5(g)(1) states that a specific objective is to review the practices and procedures followed by the broker-dealer in—

- Making the periodic computations of aggregate indebtedness and net capital under SEC rule 15c3-1 and the reserve required by SEC Rule 15c3-3.
- Making the quarterly securities examinations, counts, verifications, and comparisons and the recordation of differences required by SEC Rule 17a-13.

[#] It should be noted that some of the internal control terminology used in SEC Rule 17a-5 has not been updated to reflect the revised terminology used in AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1). When making reference to Rule 17a-5 this Guide uses the outdated internal control terminology contained in that rule in order to remain consistent with SEC regulations.

- Complying with the requirement for prompt payment for securities under section 8 of Regulation T.
- Obtaining and maintaining physical possession or control of all fully paid and excess-margin securities of customers as required by SEC Rule 15c3-3.
- If the broker-dealer is also registered as an FCM, making the periodic computations of the minimum financial requirements pursuant to Regulation 1.17 under the Commodity Exchange Act ("Act"), daily computations of the segregation requirements of section 4d(a)(2) of the Act and the Act's regulations, and the secured amount requirements of the Act and the Act's regulations.

3.78 These objectives recognize the regulatory concern for safeguarding customers' property held by broker-dealers.

3.79 The SEC requires independent auditors to issue a report on internal control. To meet this requirement, a report should (a) express an opinion on the adequacy of the practices and procedures listed above in relation to the definition of a material inadequacy as stated in Rule 17a-5(g)(3) and (b) disclose material weaknesses in internal control (including procedures for safeguarding securities) that are revealed through auditing procedures designed and conducted for the purpose of expressing an opinion on the financial statements.

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

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

3.81 SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended, gives guidance on reports on internal control based solely on an audit of financial statements that are intended for the use of management and specific regulatory agencies. SAS No. 60 defines a material weakness in internal control as a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. As used below, the term *material inadequacy* encompasses either a material weakness in internal control or a material inadequacy in the practices and procedures in SEC Rule 17a-5(g)(1) or Regulation 1.16d(1) of the CFTC, as appropriate.

3.82 In May 2006, the ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, which supersedes SAS No. 60 (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 112 is effective

for audits of financial statements for periods ending on or after December 15, 2006. Earlier implementation is permitted. Among other matters, SAS No. 112 makes the following changes to the existing guidance:

- Incorporates the definitions of the terms *control deficiency*, *significant deficiency*, and *material weakness* used in Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*
- Requires the auditor to communicate significant deficiencies and material weaknesses to management and those charged with governance
- Requires that the communication be in writing

For auditors who audit financial statements for periods ending on or after December 15, 2006, or choose to implement SAS No. 112 early, paragraphs 3.83–3.84, which have been modified to conform to SAS No. 112, along with other guidance found in SAS No. 112, will apply.

3.83 SAS No. 112 provides the following definitions:

- A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.
- A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood [footnote omitted] that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected.
- A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

3.84 Among other matters, SAS No. 112 also:

- Provides guidance to the auditor in evaluating the severity of control deficiencies based on the likelihood and magnitude of misstatements, including whether misstatements or potential misstatements are "more than inconsequential," and the possible mitigating effects of effective compensating controls that have been tested and evaluated as part of the financial statement audit.
- Identifies certain areas deficiencies in which ordinarily would be considered at least significant deficiencies in internal control
- Provides indicators of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control
- Includes an appendix containing examples of circumstances that may be control deficiencies, significant deficiencies, or material weaknesses.

3.85 As used below, the term *material inadequacy* encompasses either a material weakness in internal control or a material inadequacy in the practices

and procedures in SEC Rule 17a-5(g)(1) or Regulation 1.16d(1) of the CFTC, as appropriate.

3.86 In compliance with the SEC and CFTC rules, the auditor is required to review and conduct appropriate tests of the accounting system, control procedures, and procedures for safeguarding securities existing at the date of the examination. If no matters involving internal control (including procedures for safeguarding securities) are considered to be material weaknesses as defined above, the auditor should state this in his or her report on internal control.

3.87 However, if conditions believed to be material weaknesses are found to exist or have existed during the year, the report should disclose the nature of the weaknesses and the corrective action taken or proposed to be taken by the broker-dealer. If management has implemented control activities to correct the weaknesses, the auditor should not refer to this corrective action in his or her report unless the auditor is satisfied that the procedures are suitably designed to correct the weakness and are being applied as prescribed.

3.88 The auditor's responsibility with respect to material inadequacies as described in SEC Rule 17a-5(h)(2) and CFTC rule 1.16(e)(2) is as follows (see also Chapter 6, "Internal Control"):

If, during the course of the audit or interim work, the independent public accountant determines that any material inadequacies exist in the accounting system, internal control, and its operation including procedures for safeguarding securities, or as otherwise defined in subparagraph (g)(3), then he or she shall call it to the attention of the chief financial officer of the broker-dealer, who shall have a responsibility to inform the SEC and the designated examining authority by telegraphic notice within twenty-four hours thereafter as set forth in paragraphs (d) and (f) of SEC Rule 17a-11.

The broker-dealer shall also furnish the accountant with a copy of said notice to the regulators within the twenty-four-hour period. If the accountant fails to receive such notice from the broker-dealer within said twenty-four-hour period, or if the accountant disagrees with the statements contained in the notice of the broker-dealer, the accountant shall have a responsibility to inform the [SEC] and the designated examining authority by report of material inadequacy within twenty-four hours thereafter as set forth in SEC Rule 17a-11. Such report from the accountant shall, if the broker-dealer failed to file a notice, describe any material inadequacies found to exist. If the broker-dealer filed a notice, the accountant shall file a report detailing the aspects, if any, of the broker's or dealer's notice with which the accountant does not agree.

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

3.90 The reports shown in Appendixes C, "Report on Internal Control Required by SEC Rule 17a-5," D, "Report on Internal Control Required by SEC Rule 17a-5 for a Broker-Dealer Claiming an Exemption From SEC Rule 15c3-3," and F, "Report on Internal Control Required by CFTC Regulation 1.16 and

SEC Rule 17a-5(g)(1)," of this Guide** are appropriate if the auditor has completed the audit of the financial statements. If the auditor becomes aware of a material inadequacy that was corrected during the period but not reported by management to the SEC and the broker-dealer's designated examining authority, management's failure to report the condition would constitute a material inadequacy that should be included in the auditor's report on internal control. Pursuant to SEC Rule 17a-5(j), the report on internal control should be filed along with the annual audit report. Rule 17a-5(c)(2)(iii) provides that when the independent auditor has commented on a material inadequacy, the broker-dealer must include, in the statement of financial condition furnished to customers, a statement that a copy of such report is currently available at the principal office of the SEC and the SEC regional office for the region in which the broker-dealer has its principal place of business.³

3.91 The report shown in Appendix E, "Letter to SEC When the Broker-Dealer Has Not Made the Required Notification," should be used if an audit has not been completed and if the independent auditor disagrees with the notification made by the broker-dealer, or if the broker-dealer has failed to make the notification deemed appropriate by the auditor. Consideration should be given to the possible need to consult with legal counsel and to modify the report based on the particular circumstances.⁴

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

3.93 *Qualification of Accountant.*^{††} The SEC does not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of his or her place of residence or principal office. The SEC also does not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of his or her place of residence or principal office.

3.94 *Designation of Accountant.* SEC Rule 17a-5 also requires every broker-dealer that is required (by paragraph (d) of SEC Rule 17a-5) to file an annual report of financial statements to also file, by no later than December 10 of each year, a statement with the SEC's principal office in Washington, DC, with the regional office of the SEC for the region in which its principal place

** This edition of the Guide contains two versions of each appendix—one based on guidance in SAS No. 60 (Appendixes C, D and F) and the second version is based on guidance in SAS No. 112 (Appendixes C-1, D-1 and F-1). Please refer to paragraphs 3.81–3.84 for more information on SAS No. 60 and SAS No. 112.

³ AU section 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1), provides guidance to auditors in determining whether an engagement requires a restricted use report and if so, the elements to include in that report.

⁴ See footnote 3 to paragraph 3.90.

^{††} Although the Sarbanes-Oxley Act (the Act) is directed at "issuers" (as defined by the Act) and their auditors, privately held securities 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 Securities Exchange Act of 1934 to require *all* broker-dealers (both public and private) to be audited by a public accounting firm registered with the Public Company Accounting Oversight Board (PCAOB). However, on December 7, 2005, 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 for fiscal years ending before January 1, 2007 (see Release No. 34-52909 at www.sec.gov). The original Order, issued on August 4, 2003, and extended on July 14, 2004, was set to expire on January 1, 2006.

of business is located, and with the principal office of the designated examining authority for such broker-dealer, indicating the existence of an agreement, dated no later than December 1, with an independent public accountant covering a contractual commitment to conduct the broker-dealer's annual audit during the following calendar year. The agreement may be of a continuing nature, providing for successive yearly audits, in which case no further filing is required. However, if the agreement is for a single audit, or if the continuing agreement previously filed has been terminated or amended, a new statement must be filed by the required date.

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

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

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

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

3.98 *Replacement of Accountant.* A broker-dealer is also required to file a notice with the SEC's principal office in Washington, DC, the SEC regional office for the region in which the broker-dealer's principal place of business is located, and the principal office of the designated examining authority for such broker-dealer, no more than fifteen business days after either of the following.

- The broker-dealer has notified the accountant whose opinion covered the most recent financial statements filed under paragraph (d) of SEC Rule 17a-5 that his or her services will not be used in future engagements.
- The broker-dealer has notified an accountant who was engaged to give an opinion covering the financial statements to be filed under paragraph (d) that the engagement has been terminated.

^{††} In January 2003, the SEC adopted amendments to its requirements regarding auditor independence to enhance the independence of accountants who audit and review financial statements and prepare attestation reports filed with the SEC. In August 2003, the SEC's Office of the Chief Accountant provided responses to 35 frequently asked questions regarding the application of these rules. The last question, number 35, indicates 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 number 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.

- An accountant has notified the broker-dealer that he or she would not continue under an engagement to give an opinion covering the financial statements to be filed under paragraph (d).
- A new accountant has been engaged to give an opinion covering the financial statements to be filed under paragraph (d) without any notice of termination having been given to or by the previously engaged accountant.

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

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

Anti-Money Laundering Regulations

3.101 The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the Patriot Act) requires broker-dealers to implement certain recordkeeping and reporting requirements. They must also establish an anti-money laundering (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.

3.102 Broker-dealers must also 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.

3.103 Among other things, these rules require that firms independently test their AML programs. The independent tests should occur on an annual basis. Many broker-dealers are concerned about the independent testing requirement and its impact on their auditors' independence. It would be proper for the auditor of the broker-dealer to perform testing of anti money laundering program if it is done in accordance with attestation standards. It can be performed as an agreed upon procedure, or an attestation of management assertions. However, if performed as a consulting service, such as generating work papers, reports for the NASD or NYSE to review, the SEC staff believes this would be considered a management function, and therefore would impair the auditor's independence. Firms may use internal staff as long as they are independent from the AML program itself and have the knowledge they need to effectively evaluate a firm's AML system. 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.^{||||}

Reporting Requirements

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

3.105 The FOCUS report (Form X-17A-5) is composed of the following parts:

- *Part I.* A monthly report of selected summarized financial and operational data, filed by broker-dealers that carry customer securities accounts or clear securities transactions (Examining authorities may require other broker-dealers to file Part I on a monthly basis.)

^{||||} On January 5, 2006, the SEC approved a rule change relating to amendments of NASD Rule 3011, "Anti-Money Laundering Compliance Program." Pursuant to the USA PATRIOT Act, NASD Rule 3011 requires that each member develop and implement an AML program and specifies the minimum requirements for those programs. The rule change clarifies that in most instances firms are required to test their AML programs at least annually (on a calendar-year basis). However, the rule change allows firms that do not execute transactions for customers or otherwise hold customer accounts and do not act as an introducing broker with respect to customer accounts to test once every two years (on a calendar-year basis) rather than on an annual basis. The rule change also clarifies which firm's personnel can conduct the independent testing of a firm's AML program and who is permitted to be a firm's AML compliance person. Please refer to NASD Notice to Members 06-07 for more information.

On January 25, 2006, the SEC approved amendments to NYSE Rule 445, "Anti-Money Laundering Compliance Program," which requires NYSE members and member organizations to develop an AML Compliance Program designed to comply with the requirements of the Bank Secrecy Act. The amendments to rule 445 establish a time frame for the "independent testing" requirement, establish a standard to determine who is adequately qualified and sufficiently independent to conduct such test, and establish affiliation guidelines for AML Officers. Please refer to NYSE Information Memo 06-04 for more information.

- *Part II.* A report of general-purpose financial information that presents the financial position and the results of operations, supplemental schedules, and operational data and is filed each calendar quarter by broker-dealers that file Part I
- *Part IIA.* A quarterly report of financial information that presents the financial position and the results of operations, supplemental schedules, and operational data, filed by broker-dealers that do not carry customer securities accounts or clear securities transactions
- *Part IIB.* A quarterly report made by OTC derivatives dealers who register with the SEC under a limited regulatory structure, as discussed in paragraph 3.140 of this Guide, that includes statements of financial condition and income, computation of net capital and net capital required, capital withdrawals, and other schedules of financial and operational data
- *Schedule I.* Annual supplementary schedules reflecting certain economic and statistical data of broker-dealers on a calendar-year basis

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

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

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

Consolidation of Subsidiaries

3.109 The instructions to the FOCUS report require that certain subsidiaries be consolidated if the broker-dealer has guaranteed, endorsed, or assumed the obligations or liabilities of those subsidiaries, and permit the consolidation of other subsidiaries. (However, guarantees of specific obligations may be reflected in the firm's capital computation by a single capital charge for the amount of the item guaranteed in lieu of full consolidation.) However, if the effect of consolidating any subsidiary is to improve net capital or the net capital ratio computed pursuant to SEC Rule 15c3-1, the broker-dealer must obtain an opinion from legal counsel as of the date of the financial statements (such opinion must be renewed annually) that the net assets of the subsidiary can be liquidated and distributed to the broker-dealer within thirty calendar days. Consolidating a subsidiary for the purpose of improving net capital or the net capital ratio in the FOCUS report is not permitted unless such a legal opinion is obtained.

The Annual Audited Report

3.110 The annual audited financial statements must be filed by the following:

- Every member (with certain narrow exceptions, such as specialists that do not do business with customers, as well as option market makers on the CBOE) of a national securities exchange who transacts business in securities directly with or for persons other than members of national securities exchanges
- Every broker-dealer (other than a member) who transacts a business in securities through a medium of any member of a national securities exchange
- Every broker-dealer registered in accordance with section 15 of the Exchange Act
- OTC derivatives dealers registered pursuant to Section 15 of the Exchange Act⁵

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

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

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

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

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

- Computation of net capital and required net capital under Rule 15c3-1
- Computation for determination of reserve requirements under Exhibit A of Rule 15c3-3
- Information relating to the possession or control requirements under Rule 15c3-3

⁵ Rule 17a-12, "Reports to Be Made by Certain OTC Derivatives Dealers," includes the requirements for audited annual financial statements of OTC derivatives dealers registered pursuant to Section 15 of the Exchange Act under a limited regulatory structure, as discussed in paragraph 3.140 of this Guide.

- A schedule of segregation requirements and funds in segregation for broker-dealers with customers trading on U.S. commodity exchanges, as well as a schedule of secured amounts and funds held in separate accounts for customers trading on non-U.S. commodity exchanges
- Reconciliations (including appropriate explanations) of material differences, if any, between the following:
 - The broker-dealer's computation of net capital under Rule 15c3-1 included in the original unaudited FOCUS filing,
 - The broker-dealer's computation for determination of the reserve requirements under Exhibit A of Rule 15c3-3 included in the original unaudited FOCUS filing,
 - The schedule of segregation requirements and funds in segregation included in the original unaudited FOCUS filing, and
 - The corresponding computations made by the independent auditor based on the audited financial statements. As permitted under the SEC Letter to NYSE dated April 24, 1987, if a broker-dealer files an amended FOCUS report that contains the reconciliation and explanation of material differences between the amended report and the original report, the audit report may be reconciled with the amended FOCUS report and would include a statement as to whether any material differences are shown in the amendment.

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

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

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

3.117 According to NASD Manual, the application for an extension should:

- a. State the reasons for the requested extension,
- b. Indicate that the inability to make a timely filing is due to circumstances beyond the control of the broker-dealer if such is the case, and describe briefly the nature of such circumstances,

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

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

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

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

3.120 Similar financial statements must be filed with the SEC (for government securities broker-dealers) within sixty calendar days after the date of the financial statements and with the CFTC (for FCMs) within ninety calendar days after the date of the financial statements. Extension requests for an additional ninety calendar days may be filed with the CFTC prior to the scheduled filing date.

3.121 All annual audited financial statements that are filed with the SEC are treated as public documents unless the broker-dealer makes two separate filings. If the broker-dealer requests confidential treatment (not available for public inspection), the complete set of financial statements should be marked "CONFIDENTIAL" and a separate public document needs to be submitted, containing the auditor's report, the statement of financial condition, the related notes, and the report on internal control if that report discloses a material weakness or material inadequacy.⁶

3.122 If the broker-dealer elects to file the annual audited report with the CFTC on a confidential basis, the confidential filings must be accompanied by a letter to petition for the report to remain confidential. The confidential portion should be bound separately from the public portion, and the confidential portion marked to identify it as nonpublic. The auditor should review CFTC rule 1.10(g) in this regard. In addition to the statement of financial condition, the CFTC "public" filing also includes the supplemental schedules.⁷

3.123 The filing with the various exchanges of which the broker-dealer is a member should include both (a) the complete annual audited report filed

⁶ See footnote 3 to paragraph 3.90.

⁷ See footnote 3 to paragraph 3.90.

with the SEC and the CFTC on a confidential basis and (b) the additional filing made with the SEC and CFTC as a public document.⁸

Filings Concurrent With the Annual Audited Report

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

3.124 The auditing procedures should be sufficient to provide reasonable assurance that material inadequacies existing at the audit date would be disclosed.

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

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

- A review of the accounting system
- A review of internal control and procedures for safeguarding securities
- Procedures to test the broker-dealer's compliance with the following:
 - The periodic computations of net capital under Rule 17a-3(a)(11) and the reserve required by Rule 15c3-3(e)
 - The quarterly securities count rule (Rule 17a-13)
 - Regulation T requirements for prompt payment of securities
 - The requirements for safeguarding securities (possession and control)
 - The daily computations of the segregation and foreign set-aside requirements of the Commodity Exchange Act

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

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

Report to State Regulatory Agencies

3.129 Other filings may be required by various state regulatory agencies. The auditor should determine, by inquiry of the client, the states in which the

⁸ See footnote 3 to paragraph 3.90.

annual audited report, or portions thereof, is required to be filed and who (client or auditor) is to make such filings. Some jurisdictions (including California, Connecticut, and others) require a specific form of oath or affirmation to accompany the annual audited report. Others may require the filing of a statement of financial condition only, and not the supplemental report on internal control structure, and others may not require any financial statement filings.

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

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

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

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

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

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

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

Other Reports

Reports on Agreed-Upon Procedures for Distributions

3.136 Broker-dealers distribute securities of government-sponsored entities. In connection with those activities, government-sponsored entities may require that broker-dealers have their auditors issue reports on agreed-upon procedures concerning compliance with selling-agreement covenants. An illustrative report is shown as Appendix H, "Agreed Upon Procedures."

Rules Applicable to Broker-Dealers in Commodities and U.S. Government Securities

3.137 The following are the primary regulations under the Commodity Exchange Act and rules under the Government Securities Act of 1986 that are currently applicable to the audit of broker-dealers in commodities and government securities.

Commodities Futures Commission Merchants

3.138 The following are applicable to FCMs:

- *Part 1 (17 CFR Ch 1 Part 1—General Regulations Under the Commodity Exchange Act)*
 - Regulation 1.10, "Financial Reports of Futures Commission Merchants and Introducing Brokers"
 - Regulation 1.12, "Maintenance of Minimum Financial Requirements by Futures Commission Merchants and Introducing Brokers"
 - Regulation 1.16, "Qualifications and Reports of Accountants"
 - Regulation 1.17, "Minimum Financial Requirements for Futures Commission Merchants and Introducing Brokers"
 - Regulations 1.20-1.30, "Segregation of Customers' Funds"
 - Regulations 1.31-1.37, "FCM Recordkeeping Requirements"
- *Part 30 (17 CFR Ch 1 Part 30—Foreign Futures and Foreign Options Transactions)*
 - Regulation 30.7, "Treatment Foreign Futures and Foreign Options Customers' Secured Amount"
- *Part 32 (17 CFR Ch 1 Part 32)*
 - "Regulation of Commodity Option Transactions"
 - Commodity Exchange Act (7 USC section 4d(2)), "Segregation Requirements"

Government Securities Broker-Dealers

3.139 The following are applicable to government securities broker-dealers under 17 CFR Ch IV:

- Part 402, "Financial Responsibility"
- Part 403, "Protection of Customer Securities and Balances"
- Part 404, "Recordkeeping and Reservation of Records"
- Part 405, "Reports and Audit"

OTC Derivatives Dealers

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

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

Annual Compliance Certification

3.142 NASD Rule 3013, "Annual Certification of Compliance and Supervisory Processes," requires members to (1) designate a chief compliance officer (CCO) and (2) have the chief executive officer (CEO) or equivalent officer certify annually that the member has in place processes to establish, maintain, review, test, and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable NASD rules, Municipal Securities Rulemaking Board (MSRB) rules, and federal securities laws and regulations. Recently amended NYSE Rule 342.30, "Annual Report," contains similar requirements. First annual certification pursuant to these rules had to be executed by April 1, 2006.

Chapter 4

Financial Statement Presentation and Classification

Introduction

4.01 Broker-dealers are guided in their preparation of financial statements primarily by generally accepted accounting principles (GAAP) for business enterprises in general. However, broker-dealers are further subject to SEC Rule 17a-5 and the Financial and Operational Combined Uniform Single (FOCUS) forms thereunder. That rule requires, in addition to monthly and quarterly filings on the prescribed forms (Form X-17A-5—FOCUS Parts I, II and IIA), annual audited financial statements, which include a statement of financial condition, a statement of income or operations, a statement of cash flows, a statement of changes in stockholders' or partners' or sole proprietor's equity, and a statement of changes in liabilities subordinated to claims of general creditors. Also required are certain supporting schedules for various specified computations. These are illustrated in Exhibits 4-1 to 4-9 at the end of the chapter.

4.02 In addition to the disclosures shown in Exhibit 4-8, "Notes to Consolidated Financial Statements," at the end of this chapter, there may be certain other disclosures required under Regulation S-X of the Securities and Exchange Commission (SEC) for those companies that are registered under section 12(b) or 12(g) of the Securities Exchange Act of 1934. Regulation S-X does not apply to the financial statements filed with the SEC under Rule 17a-5, but the independence requirements of Regulation S-X do apply.*

4.03 Broker-dealers commonly prepare their financial statements on a single-year basis, which complies with the requirements of SEC Rule 17a-5. Coexisting financial statements for other than regulatory filings (such as bank lending requirements or reports to shareholders) are also generally prepared on a single-year basis.

4.04 Over-the-counter (OTC) derivatives dealers registered pursuant to Section 15 of the Exchange Act under an alternative regulatory framework as discussed in paragraph 3.140 of this Guide, are subject to SEC Rule 17a-12. Rule 17a-5 states that an OTC derivatives dealer may comply with Rule 17a-5 by complying with the provisions of Rule 17a-12. The rules governing reporting for OTC derivatives dealers remain substantially the same as for fully regulated broker-dealers. However, they have been tailored to the business

* In January 2003, the SEC adopted amendments to its requirements regarding auditor independence to enhance the independence of accountants who audit and review financial statements and prepare attestation reports filed with the SEC. In August 2003, the SEC's Office of the Chief Accountant provided responses to 35 frequently asked questions regarding the application of these rules. The last question, number 35, indicates 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 number 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/ocafaqauidind080703.htm.

of OTC derivatives dealers. Readers should refer to the requirements of Rule 17a-12 for guidance on reports to be made by OTC derivatives dealers.

4.05 Some of the unique attributes of the financial statements and the accounts or captions appearing therein, as they relate to broker-dealers, are discussed in the following sections.

Financial Statements

Statement of Financial Condition

4.06 The audited statement of financial condition should be in a format and on a basis consistent with the totals reported on the statement of financial condition contained in Part II or Part IIA of the FOCUS report, as filed by the broker-dealer. This presentation should conform with GAAP. See paragraph 4.08 for a discussion on subordinated liabilities and stockholders' equity, or partners' or proprietor's capital. However, current and noncurrent classifications are ordinarily not presented in the statement of financial condition because such a distinction normally has little meaning for brokers and dealers.

4.07 The statement of financial condition, when presented with the other basic financial statements, should disclose on the face of the statement or in a note the components of stockholders' equity (for example, preferred stock, common stock, additional paid-in capital, and retained earnings). However, the statement of financial condition presented alone (for example, the statement of financial condition bound separately for the SEC; see the discussion of confidentiality in the section of Chapter 3 entitled "The Annual Audited Report") and the statement of financial condition furnished to customers (see the section of Chapter 3 entitled "Financial Statements to Be Furnished to Customers of Securities Broker-Dealers") has traditionally not disclosed the components of stockholders' equity.

4.08 Subordinated liabilities and stockholders' equity (or partners' or proprietor's capital) should be presented separately. Because of the unique characteristics of qualifying subordinated liabilities, disclosure should be made in the notes to the financial statements or the separate statement of financial condition of the amount of subordinated debt for which six months' notice has been given of intent to withdraw.

Statement of Income or Operations

4.09 The statement of income or operations should be in a format that is consistent with the statement contained in Part II or Part IIA of the FOCUS report, and it should disclose separately the sources of the broker-dealer's revenues (such as brokerage commissions, trading and investment gains or losses, underwriting profits or losses, fee income, dividends, and interest). Expenses should be reported by major types (such as employee compensation and benefits, communications, occupancy and equipment, interest, floor brokerage, and clearance fees).

Statement of Cash Flows

4.10 The statement of cash flows is required when financial statements present both the statement of financial condition and the statement of income or operations in conformity with GAAP. Broker-dealers report their trading securities activities in the operating section of the statement of cash flows. This

presentation is appropriate for the securities industry because, unlike other industries, broker-dealers' business is to acquire and finance securities.

Statement of Changes in Ownership Equity

4.11 The statement of changes in ownership equity should be in a format that is consistent with the statement contained in Part II or Part IIA of the FOCUS report. This statement is required whether the reporting broker-dealer is a corporation, partnership, or sole proprietor. It should disclose the principal changes in the equity accounts of the broker-dealer during the periods for which a statement of income or operations is presented. After the issuance of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, some instruments which previously had been classified as equity are now considered a liability and should be classified as such. Examples include certain mandatorily redeemable preferred and common stock, general partner buy/sell arrangements and other similar arrangements. (Please refer to paragraph 7.47 and 7.48 for more information.) Separate classification on the face of the financial statements and disclosure in the footnotes should be made for any "redeemable" forms of equity. (See FASB Statement No. 150—paragraphs 18–19 and 26–28—and EITF Topic D-98, *Classification and Measurement of Redeemable Securities*, for additional guidance.)

Statement of Changes in Liabilities Subordinated to Claims of General Creditors

4.12 The SEC requires a statement showing the increases and decreases to subordinated liabilities for each year being reported on. This statement is required even if no increases or decreases in subordinated liabilities occur during the year; however, no statement is required if no subordinated liabilities exist at any time during the year.

Consolidation of Subsidiaries[†]

4.13 Annual audited financial statements of a company and its subsidiaries that are presented in conformity with GAAP are presented on a consolidated basis in accordance with ARB No. 51, *Consolidated Financial Statements*, FASB Statement No. 94, *Consolidation of All Majority-owned Subsidiaries*,[‡] FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities—an interpretation of ARB No. 51*

[†] Broker-dealers may act as general partners in private equity, merchant banking and asset management partnerships. In June 2005, the EITF reached a consensus on EITF Issue No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights." The EITF consensus requires a general partner in a limited partnership to consolidate the limited partnership unless the presumption of control is overcome. The general partner may overcome this presumption of control and not consolidate the entity if the limited partners have: (a) the substantive ability to dissolve or liquidate the limited partnership or otherwise remove the general partner without having to show cause; or (b) substantive participating rights in managing the partnership. This guidance became effective upon ratification by the FASB on June 29, 2005 for all newly formed limited partnerships and for existing limited partnerships for which the partnership agreements have been modified. For all other limited partnerships, the guidance is effective no later than the beginning of the first reporting period in fiscal years beginning after December 15, 2005.

[‡] On February 23, 1999, the FASB released an exposure draft (revised) of a proposed FASB Statement, *Consolidated Financial Statements: Purpose and Policy*—Revision of Exposure Draft issued October 16, 1995, that, in addition to other matters, would supersede FASB Statement No. 94. The FASB decided in 2001 to temporarily suspend work on consolidation policy issues, and focus

(continued)

(Interpretation No. 46R), and FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125* (which provides special guidance for consolidation of qualifying SPEs). However, audited financial statements filed pursuant to Part II or Part IIA of the FOCUS report may have different consolidation requirements. If the statement of financial condition, filed on Part II or Part IIA of the FOCUS report, is not on a consolidated basis, or if consolidation on Part II or Part IIA of the FOCUS Report is on a "one line" (equity) basis, it may differ from the statement reported on by the independent auditor. The SEC requires that such differences, if material, be disclosed in a note to the audited financial statements or included as supplementary information.

4.14 In addition, the SEC requires disclosure of summary financial information (including assets, liabilities, and net worth) concerning subsidiaries consolidated in the financial statements presented in conformity with GAAP if that consolidation differs from the presentation in the unaudited Part II or Part IIA FOCUS filing. Further, for subsidiaries consolidated under the flow-through capital benefits of Appendix C of SEC Rule 15c3-1, the effect of the consolidation on net capital and required net capital of the broker-dealer must be disclosed in the notes to the statement of financial condition furnished to customers.

Supplementary Schedules

4.15 Certain supplementary schedules are required to be filed with the financial statements. These supplementary schedules should be presented in the format required by SEC and CFTC rules and should be filed as a part of the FOCUS report. The independent auditors' report is required to cover these schedules, which should be filed as of the audit date.

Computation of Net Capital Pursuant to SEC Rule 15c3-1

4.16 This schedule shows the computation of the net capital and required net capital of the broker-dealer. A reconciliation is required if material differences exist between the computation reported on by the independent auditor and the broker-dealer's original unaudited filing of Part II or Part IIA of the FOCUS report.¹ If no material differences exist, a statement to that effect must be made in the schedule.

(footnote continued)

its efforts on developing interpretive guidance for special situations, in particular variable interest entities. However, following the issuance of FASB Interpretation No. 46R, *Consolidation of Variable Interest Entities*, the FASB decided to resume work on certain issues related to consolidation policy.

Currently, the FASB has on its agenda a long-term project entitled *Consolidations: Policy and Procedure* to develop comprehensive accounting guidance on accounting for affiliations between entities, including reconsideration of ARB No. 51, *Consolidated Financial Statements*. The International Accounting Standards Board (IASB) also has an active project on its agenda to reconsider its guidance in this area. In April 2004, the IASB and FASB agreed that an objective of both their projects is the development of a common, high-quality standard on consolidation policy. The objective of this research project is to identify and develop plans for the next steps in achieving the FASB's long-term objectives, including plans for coordinating the activities of the FASB with those of the IASB. The FASB began those staff research and planning activities in late 2005.

¹ As permitted under the SEC Letter to NYSE dated April 24, 1987, if a broker-dealer files an amended FOCUS report that contains the reconciliation and explanation of material differences between the amended report and the original report, the audit report may be reconciled with the amended FOCUS report and would include a statement as to whether any material differences are shown in the amendment.

Computation for Determination of Reserve Requirements Pursuant to Rule 15c3-3

4.17 This schedule shows the computation of the required deposit in special reserve bank accounts for the exclusive benefit of customers. A reconciliation is required if material differences exist between the computation reported on by the independent auditor and the computation filed previously by the broker-dealer in the original unaudited FOCUS report.² If no material differences exist, a statement to that effect must be made in the schedule.

Information Relating to Possession or Control Requirements Under Rule 15c3-3

4.18 This schedule discloses the number of security positions and the related market value of securities required to be in possession or control that had not been reduced to possession or control in the proper time frame because (a) properly issued segregation instructions were not acted upon or (b) segregation instructions were not issued. In addition, for those items not in possession or control, the current status of the reduction of those items to possession and control should be included within the schedule.

Schedules of Segregation Requirements and Funds in Segregation Pursuant to the Commodity Exchange Act

4.19 The segregation schedule shows the computation of the amount of funds that must be segregated for customers trading on U.S. commodity exchanges and the total funds segregated by the broker-dealer to meet those requirements. The secured amount schedule shows the computation of funds required to be set aside in separate accounts for customers trading on non-U.S. commodity exchanges and the amount of funds in such separate accounts.

Statement-of-Financial-Condition Account Descriptions

4.20 Many statement-of-financial-condition accounts contained in a broker-dealer's general ledger are self-explanatory. The captions discussed in the following paragraphs require special comment because they contain certain characteristics that are unique to broker-dealers.

Cash

4.21 Cash in banks subject to withdrawal restrictions, restricted deposits held as compensating balances, and cash segregated in compliance with federal or other regulations (such as cash deposited in a special reserve bank account for the exclusive benefit of customers pursuant to SEC Rule 15c3-3) should be classified separately in the statement of financial condition or disclosed in the notes to the financial statements. Because of the attributes of segregated cash and related assets under CFTC rules, many futures commission merchants and some broker-dealers disclose in the notes a summary of the computation of segregation requirements and funds in segregation.

² See footnote 1 in paragraph 4.16.

Memberships in Exchanges

4.22 Exchange memberships provide the broker-dealer with the right to do business on the exchanges of which the broker-dealer is a member. Some exchange memberships also represent an ownership interest in the exchange. Due to the demutualization of some exchanges, membership may not be aligned with ownership in the exchange as trading privileges are disaggregated from ownership. Many broker-dealers have memberships in several exchanges and have more than one membership in any particular exchange. Memberships are usually registered in the names of individuals who are affiliated with the broker-dealer. A membership held in the name of an individual is considered to be an asset of the broker-dealer if it is held by the broker-dealer under an agreement (such as an ABC agreement)³ that would require the member, upon leaving the broker-dealer, to do one of the following:

- a. Pay the member organization the amount necessary to purchase another membership (if the named individual wished to retain the membership)
- b. Sell the membership and pay the proceeds over to the member organization
- c. Transfer the membership for a nominal consideration to a person designated by the member organization and satisfactory to the exchange

4.23 A membership may be considered to be an asset of the broker-dealer if its use has been contributed to the broker-dealer under a formal or informal subordination agreement.

Receivables From and Payables to Broker-Dealers and Clearing Organizations

4.24 Receivables from broker-dealers and clearing organizations may include amounts receivable for securities failed to deliver, certain deposits for securities borrowed, amounts receivable from clearing organizations relating to open transactions, good-faith and margin deposits, and commissions and floor-brokerage receivables. Payables to broker-dealers and clearing organizations include amounts payable for securities failed to receive, certain deposits received for securities loaned, amounts payable to clearing organizations on open transactions, and floor-brokerage payables. In addition, the net receivable or payable arising from unsettled trades would be reflected in those captions.

4.25 If a broker-dealer clears transactions on behalf of or through correspondents, there may be balances in the omnibus accounts with one or more of the correspondents. Balances included in this category may be shown separately as due from or due to correspondent brokers.

4.26 *Fail-to-Deliver.* A broker-dealer that sells securities, either for its own account or for a customer's account, but does not deliver the securities on the

³ ABC agreement is an agreement between a brokerage firm and one of its employees spelling out the firm's rights when it purchases a NYSE membership for the employee. Only individuals can be members of the NYSE, and it is common practice for a firm to finance the purchase of a membership, or seat, by one of its employees. The NYSE approved ABC agreement contains the following provisions regarding the future disposition of the seat: (1) the employee may retain the membership and buy another seat for an individual designated by the firm, (2) the employee may sell the seat and give the proceeds to the firm, or (3) the employee may transfer the seat to another employee of the firm.

settlement date records the selling price, including any accrued interest, as an asset in the receivable account due from broker-dealers. This asset will be collected upon delivery of the securities.

4.27 *Fail-to-Receive.* A broker-dealer that purchases securities, either for its own account or for a customer's account, but does not receive the securities on the settlement date records the amount of money representing the purchase price of the securities, including any accrued interest, as a liability to the selling broker-dealer. This liability is paid when the securities are received by the purchasing broker-dealer.

4.28 *Clearing Organizations Receivables/Payables.* As described in Chapter 1, "The Securities Industry," clearing organizations provide efficient and orderly trade clearance and settlement services for which broker-dealers pay fees. Clearing organizations perform posttrade processing and trade comparisons among numerous broker-dealers and act as settlement agents between buying and selling broker-dealers. In general, the majority of financial instrument transactions are compared and cleared through a clearing organization.

4.29 All continuous net settlement transactions (see paragraph 1.37 for a description of these transactions) are netted at each clearing organization to one cash settlement position. Therefore, if the contract amount of the securities received (purchased) is greater than that delivered (sold), the broker-dealer records a payable to the clearing organization for the net movement.

4.30 *Securities Borrowed.* Broker-dealers borrow securities from other broker-dealers or institutions for the following purposes:

- To deliver them in place of securities not available because customers or broker-dealers sell short (sell securities not owned), customers sell securities before they deliver them, or customers deliver securities lacking proper endorsements, preventing their delivery to buyers
- To lend them in connection with finder or conduit transactions
- To be used for other purposes permitted under Federal Reserve Regulation T (Regulation T)

4.31 Broker-dealers may advance cash, pledge securities as allowed under Regulation T (permitted securities), or issue letters of credit as collateral for borrowed securities. Cash is typically in excess of the market value of the securities borrowed. The amount of collateral required may increase or decrease depending on changes in the value of the securities. The borrowing broker-dealer normally receives a rebate on the cash that it exchanges for the securities borrowed.

4.32 *Securities Loaned.* Securities are loaned to other broker-dealers as a method of financing or in a finder or conduit business. Collateral, generally cash, is received for the securities loaned. A rebate is paid by the lending broker-dealer on the money received for the securities lent. It should be noted that SEC Rule 15c3-3 specifies that customers' fully paid and excess margin securities may not be lent, except as specifically allowed under the rule.

4.33 Accounting Principles Board Opinion No. 10, *Omnibus Opinion—1966*, paragraph 7, states that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." A debtor having a valid right of setoff may offset the related asset and liability and report the net amount.

4.34 FASB Interpretation No. 39 defines right of setoff and specifies what conditions must be met to have that right. Specifically, FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, provides in paragraph 5c that a right of setoff exists when all of the following conditions are met.

- a. Each of *two* parties owes the other determinable amounts.
- b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
- c. The reporting party intends to set off.
- d. The right of setoff is enforceable at law.

Securities borrowed and securities loaned transactions that do not have explicit settlement dates do not meet the requirement in paragraph 5c of FASB Interpretation No. 39. Appendix D-43 to the *EITF Abstracts* contains the FASB staff response to inquiries about the nature of support required for an assertion in financial statements that a right of setoff is enforceable at law. Balances arising from securities borrowed and loaned transactions that are accounted for as secured borrowings are presented gross on the statement of financial condition because they do not have explicit settlement dates. FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, provides specific criteria for determining whether a securities lending transaction is to be accounted for as a sale or as a secured borrowing (see Chapter 7, "Accounting Standards," for a discussion of secured borrowing) and provides an illustration of the latter.

Receivables From and Payables to Customers

4.35 The term *customers* generally excludes other broker-dealers; persons who are principal officers, directors, and stockholders; and persons whose securities or funds are part of the regulatory net capital of the broker-dealer. Another broker-dealer's account can be classified as a customer if the account is carried as an omnibus account in compliance with Regulation T. The accounts of principal officers, directors, and stockholders may be combined in the customer captions if they are not material and the combination is disclosed in the oath that is required to accompany the annual audited FOCUS report.

Securities Sold Under Agreements to Repurchase

4.36 A repurchase transaction (repo) is, in its simplest form, a sale of a security coupled with an agreement by the seller to repurchase the same or substantially the same security⁴ from the same counterparty at a fixed or determinable price (generally the original sale price plus accrued interest) within a fixed or variable time period. FASB Statement No. 140 provides specific criteria for determining whether repos should be accounted for as sales or as secured borrowings (see the discussion of secured borrowings in Chapter 7).

Securities Purchased Under Agreements to Resell

4.37 A reverse repurchase agreement (reverse repo or resale), is, in its simplest form, the purchase of a security at a specified price with an agreement to sell the same or substantially the same security to the same counterparty at a fixed or determinable price at a future date. Repos and reverse repos that are accounted for as secured borrowings (see Chapter 7 for a discussion) should be

⁴ The meaning of *substantially the same* is explained in paragraph 48 of FASB Statement No. 140.

recorded as both assets and liabilities on the statement of financial condition and may be netted if the conditions of FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*, are met.

Securities Owned and Securities Sold, Not Yet Purchased

4.38 Proprietary securities transactions entered into by the broker-dealer for trading or investment purposes are included in "Securities Owned and Securities Sold, Not Yet Purchased."

4.39 Although proprietary trading is frequently thought of as purchasing securities for sale to others, trading securities for the broker-dealer's own account sometimes leads to a liability for the market value of securities sold but not yet purchased, that is, sold short. The broker-dealer is then obligated to purchase the securities at a future date at the then-current market price.

4.40 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. The mark to market of fixed-income securities owned that were purchased at a discount or premium is composed of accreted interest income or changes in market valuations of the securities or both. Consideration should be given to reporting these components separately as interest income and trading gains and losses, respectively. See Chapter 7 for a more complete discussion of valuing securities owned and securities sold, not yet purchased.

4.41 Specific requirements regarding joint accounts with other broker-dealers are included in the instructions to the FOCUS report. For joint accounts carried by the broker-dealer, the applicable portion of the securities or other positions should be included in the appropriate securities owned or other classifications, and the other parties' interests in the ledger balance are included in receivables or payables. If the joint account is carried by another broker-dealer, the share of the broker-dealer being reported on should be determined with a contraliability to or receivable from the carrying broker-dealer.

4.42 Broker-dealers acting as principals in underwriting and when-issued contracts have contractual commitments. Disclosure should be made of such commitments. The broker-dealer's share (assuming such share is not merely contingent) in underwriting or joint accounts with other broker-dealers for issued securities should be included with its trading accounts.

Bank Loans

4.43 Bank loans represent obligations incurred by a broker-dealer to finance securities purchases by customers on margin; to satisfy amounts owed for settling securities purchases, net of sales; to finance the firm's securities inventories; or for other corporate purposes. These loans may be secured or unsecured. Secured bank loans are generally collateralized by marketable securities. Broker-dealers should disclose in the notes to the financial statements the general attributes of the loans, including the collateral pledged.⁵

⁵ Paragraph 15 of FASB Statement No. 140 addresses the accounting for collateral and requires, in some cases, that a debtor reclassify an asset pledged as collateral to indicate that it is encumbered. The standards for accounting for noncash collateral in paragraph 15 of FASB Statement No. 140 require that the debtor reclass noncash collateral that the secured party has the right by contract

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4.44 Customer-owned securities may be used only to collateralize customer loans. Unsecured loans are always firm loans. Only securities belonging to the firm or its subordinated lenders, partners, principal officers, or directors can be used as collateral for firm loans. Loans that are collateralized by securities not owned by the broker-dealer but that are held pending delivery or held for the account of other broker-dealers are considered nonfirm, noncustomer loans. However, securities that have been sold to a delivery versus payment (DVP) customer or to another broker-dealer and that have not yet been paid for can be pledged as collateral for a firm bank loan. Noncustomer bank loans are typically used to finance positions of a broker-dealer correspondent or an affiliate. Once a customer's securities are fully paid for or constitute excess margin, they must be promptly removed from bank loans and segregated as required by SEC Rule 15c3-3.

Commitments, Contingencies and Guarantees

4.45 There are many transactions that may be interpreted to be a guarantee' which may require specific recognition and measurement within the financial statements. FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34*, discusses these transactions. Examples include a parent's guarantee of a subsidiary's debt, indemnifications to service providers or counterparties, certain written options and certain credit default swaps. This Interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of certain guarantees, a liability for the fair value of the obligation undertaken in issuing the guarantee. Paragraph 7 of Interpretation 45 lists the types of guarantees that are not subject to its initial recognition and initial measurement provisions, but are subject to its disclosure requirements.

Subordinated Borrowings

4.46 Broker-dealers use subordinated loans as sources of regulatory capital. These loans may be cash loans or secured demand notes. They are often made by persons associated with the broker-dealer, usually a partner, parent corporation, or principal shareholder, officer, employee, or family relation of the foregoing. The subordinated loans must be subject to a qualified subordination agreement or to a qualified secured demand note collateral agreement approved by the broker-dealer's designated self-regulatory organization to qualify as capital for purposes of computing the broker-dealer's net capital.

4.47 In a typical subordinated cash loan agreement, the lender lends cash to the broker-dealer and in return receives from the broker-dealer a written promise in the form of a note, which sets forth the repayment terms, the interest rate, and the provisions under which the lender agrees to subordinate its claims to the claims of the general creditors of the broker-dealer.

(footnote continued)

or custom to sell or repledge. Cash "collateral," sometimes used, for example, in securities lending transactions, shall be derecognized by the payer and recognized by the recipient, not as collateral, but rather as proceeds of either a sale or a borrowing. Paragraph 17 of FASB Statement No. 140 requires certain disclosures for collateral.

4.48 A secured demand note is an interest-bearing promissory note executed by the lender and is payable upon demand of the broker-dealer to which it is contributed. These notes are generally collateralized by marketable securities. Upon demand, the note becomes due and collectible. The right to demand payment may be conditioned upon the occurrence of certain events.

4.49 The lender actually retains ownership of the collateral, benefiting from increases, and bearing the risk for decreases, in its value. Securities pledged as collateral must be fully paid and must be in bearer form or registered in the name of the broker-dealer or its custodian, which allows the securities to be used by the broker-dealer. The lender may withdraw any excess collateral or substitute cash or other securities as collateral. The securities received as collateral and cash, if any, would be recorded in a secured demand note account similar to a customer account. (Also see FASB Statement No. 140, paragraph 15, which determines the financial reporting treatment of collateral.)⁶

4.50 If a subordinated loan or collateral securing a secured demand note is subject to a satisfactory subordination agreement, as defined in Appendix D of SEC Rule 15c3-1, it will qualify as capital when computing the broker-dealer's net capital.

Income Statement Account Descriptions

4.51 Many income statement accounts of broker-dealers are analogous to those of other entities. This Audit and Accounting Guide (Guide) discusses those income statement accounts that arise based on transactions that are typical to broker-dealers. The income statement accounts of broker-dealers include the following:

- Commission income
- Interest income and expense
- Dividend income and expense
- Trading gains and losses
- Underwriting income or loss
- Management and investment advisory income
- Floor brokerage
- Exchange fees
- Occupancy
- Account executive and other employee compensation
- Communications and data processing

Commission Income

4.52 Acting as an agent, a broker-dealer may buy and sell securities on behalf of its customers. In return for such services, the broker-dealer charges a commission. Each time a customer enters into a buy or sell transaction, a commission is earned by the broker-dealer for its selling and administrative efforts. For securities purchased, the commission is recorded as a receivable from customers; for securities sold, it is recorded as reductions in the payable to customers.

⁶ See footnote 5 in paragraph 4.43.

4.53 Commissions earned are usually related to the broker-dealer's customers' trading volume and the dollar amounts of the trades. Those relationships are important when considering analytical procedures relating to commission income.

Interest Income and Expense

4.54 The sources of interest income earned by a broker-dealer include—

- Interest earned on reverse repurchase transactions.
- Interest charged on debit balances in customer margin accounts. A broker provides financing to its customers by allowing them to purchase on credit in return for which the broker-dealer charges interest.
- Interest income earned by the broker-dealer on its trading and investment portfolio, including the accretion of discounts and the amortization of premiums.
- Interest earned on securities-borrowed transactions in which the broker-dealer has borrowed securities from another broker-dealer and in return has deposited cash with the other broker-dealer. The other broker-dealer pays interest (commonly known as a rebate) for the use of the cash.

4.55 Interest expense typically arises from the following:

- Interest on cash borrowings to finance payment for securities purchased
- Interest or rebates paid on cash collateral received for securities loaned to others
- Interest on cash collateral received in repurchase transactions
- Interest to subordinated and other lenders
- Payments in lieu of interest on securities sold short

Dividend Income and Expense

4.56 Broker-dealers may earn dividend income from equity securities owned and may incur payments in lieu of dividends from equity securities sold, not yet purchased.

Trading Gains and Losses

4.57 A broker-dealer may buy and sell securities for its own account. The profit or loss is measured by the difference between the acquisition cost and the selling price or current market or fair value. Trading gains and losses, which are composed of both realized and unrealized gains and losses, are generally presented net.

Underwriting Income or Loss

4.58 A broker-dealer may underwrite a security offering by contracting to buy the issue either at a fixed price or a price based on selling the offering on a best-effort basis. The difference between the price paid by the public and the contract price less the related expenses represents the underwriting income or loss.

Management and Investment Advisory Income

4.59 Many broker-dealers provide investment advice, research, and administrative services for customers. For such services, the broker-dealer receives a fee that may be based on the net assets of the fund or the account. Therefore, such income may correlate with the size of the funds or accounts managed.

Floor Brokerage

4.60 Broker-dealers often use other brokers to execute trades on their behalf. The trading broker-dealer becomes a customer of the executing broker-dealer and pays a floor brokerage fee. Such fees are paid periodically either directly to the executing broker-dealer or through a clearinghouse.

Exchange Fees

4.61 Exchange fees are charged by securities exchanges for the privilege of trading securities listed on that exchange. Some fees vary with the related volume, while others are fixed. For transaction charges, each broker-dealer submits a monthly report of net commissions earned on transactions executed on the exchange. This report is used for the self-determination of the exchange fee. Floor brokerage and exchange fees generally vary proportionally with the volume of trades executed by the broker-dealer on the exchange.

Occupancy

4.62 Occupancy expenses generally include rent, electricity, and depreciation on fixed assets. Rent can be a significant expense for broker-dealers with large retail networks and numerous branch offices. For this reason, retail broker-dealers tend to have higher occupancy costs than do large institutional dealers, which tend to have more concentrated office sites.¹¹

Account Executive and Other Employee Compensation

4.63 Account executive compensation represents commissions paid to account executives based on their production, the revenue they generate for the firm. Commission rates for sales representatives are somewhat standardized but can vary depending on the individual account executive's employment terms, customer base (for example, institutional or retail), production volume, and type of product sold. The production on which account executives are paid includes the following:

- Commission revenue from agency trades
- Fee revenue from assets managed

¹¹ On February 7, 2005, the Office of the Chief Accountant of the SEC sent a letter to the AICPA Center for Public Company Audit Firms in which it expressed its views regarding certain operating lease accounting matters and their application under GAAP. The letter specifically addresses the appropriate accounting for (1) the amortization of leasehold improvements by a lessee in an operating lease with lease renewals, (2) the pattern of recognition of rent when the lease term in an operating lease contains a period where there are free or reduced rents (commonly referred to as "rent holidays"), and (3) incentives related to leasehold improvements provided by a landlord/lessor to a tenant/lessee in an operating lease. Financial service institutions, especially those that have numerous branch locations under leases, should review this guidance to ensure that lease accounting is properly applied. The reader can view the SEC letter at <http://www.sec.gov/info/accountants/staffletters/cpcf020705.htm>.

Also, in November 2005, the AICPA issued a set of Technical Practice Aids (TPAs) in the form of questions and answers related to accounting for operating leases. These TPAs are available on the AICPA Web site and can be accessed at www.aicpa.org/members/div/acctstd/general/recent_tpas.asp.

- Selling concessions from underwriting sales
- Sales credits or trading allowances from principal transactions

4.64 Account executive and other employee compensation includes employee salaries, bonuses, payroll taxes, and employee benefits. These expenses are not significantly different for broker-dealers than for other industries, except that at broker-dealers, bonuses usually represent a greater percentage of an individual's total compensation. In the event account executives or employees of a broker-dealer are compensated with equity of the broker-dealer or a related entity, FASB Statement No. 123 (revised 2004), *Share-Based Payment*, should be referred to for guidance. This pronouncement generally requires companies to recognize the value of employee stock options and similar awards as compensation expense over the requisite service period (usually the vesting period).

Communications and Data Processing

4.65 Communications and data processing expenses tend to be very high for broker-dealers because of their dependence on communication and information networks. Traders, account executives, and investment bankers constantly use the telephone to interact with customers, other broker-dealers, and branch locations; they use communication lines to receive quotation, ticker, and news services; and they use direct computer links to other broker-dealers, branches, clearing organizations, exchanges, analytical services, and major customers.

Disclosures

Disclosures of Certain Significant Risks and Uncertainties

4.66 AICPA Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, requires broker-dealers to include in their financial statements disclosures about (a) the nature of their operations and (b) the use of estimates in the preparation of their financial statements. Following are illustrations of the application of these disclosure requirements by a broker-dealer:

- *Nature of operations.* Standard broker-dealer operates seven branches in rural and suburban communities in Minnesota and Nebraska. The broker-dealer's primary source of revenue is providing brokerage services to customers, who are predominately small and middle-market businesses and middle-income individuals.
- *Use of estimates in the preparation of financial statements.* The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

4.67 If specified disclosure criteria are met, SOP 94-6 also requires broker-dealers to include in their financial statements disclosures about (a) certain significant estimates and (b) current vulnerability due to certain concentrations.

Following is a discussion of the application of SOP 94-6 by a broker-dealer to example events and circumstances that meet the disclosure criteria.

4.68 *Certain Significant Estimates.* Paragraphs 12 and 13 of SOP 94-6 require disclosure regarding estimates used in the determination of the carrying amounts of assets or liabilities, or in disclosure of gain or loss contingencies if known information available prior to issuance of the financial statements indicates that both of the following criteria are met:

- a. It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.
- b. The effect of the change would be material to the financial statements.

4.69 Paragraph 14 of SOP 94-6 says the disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term. Paragraph 14 further requires that, if the estimate involves a loss contingency covered by FASB Statement No. 5, *Accounting for Contingencies*, the disclosure should also include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.⁷

4.70 Examples of uncertainties that may fall in one or more of these categories found at certain broker-dealers include the following:

- Significant inventory positions that were valued as of a specific time
- Estimates made regarding the value of securities that have no ready market (such as valuations made in good faith by management)

4.71 Paragraph 18 of SOP 94-6 gives examples of assets and liabilities and related revenues and expenses, and of disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances existing at the date of the financial statements, may be based on estimates that are particularly sensitive to change in the near term. Besides good-faith valuations of securities made by management, examples of similar estimates often included in broker-dealers' financial statements include the following:

- Impairment of long-lived assets, for example, assets related to marginal branches
- Estimates involving assumed prepayments, for example, mortgage-related derivatives
- Lives of identifiable intangible assets

⁷ As noted in paragraph B-23 of SOP 94-6, paragraph 10 of FASB Statement No. 5 requires reporting entities to disclose certain loss contingencies, as follows:

If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 are not met, or if an exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 8, disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made. [Emphasis added, footnote omitted.]

4.72 *Current Vulnerability Due to Certain Concentrations.* Paragraph 21 of SOP 94-6 requires broker-dealers to disclose the concentrations described in paragraph 22 of this SOP if, based on information known to management prior to issuance of the financial statements, all of the following criteria are met.

- a. The concentration exists at the date of the financial statements.
- b. The concentration makes the broker-dealer vulnerable to the risk of a near-term severe impact.
- c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

4.73 The following concentrations described in SOP 94-6 paragraph 22 require disclosure if they meet the criteria of paragraph 21 of the same SOP.

- a. *Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor.* The potential for the severe impact can result, for example, from total or partial loss of the business relationship. For purposes of SOP 94-6, it is always considered at least reasonably possible that any customer will be lost in the near term.
- b. *Concentrations in revenue from particular products, services, or fund-raising events.* The potential for the severe impact can result, for example, from volume or price changes or the loss of patent protection for the particular source of revenue.
- c. *Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's operations.* The potential for the severe impact can result, for example, from changes in the availability to the entity of a resource or a right.
- d. *Concentrations in the market or geographic area in which an entity conducts its operations.* The potential for the severe impact can result, for example, from negative effects of the economic and political forces within the market or geographic area. For purposes of SOP 94-6, it is always considered at least reasonably possible that operations located outside an entity's home country will be disrupted in the near term.

4.74 Examples of concentrations found at a broker-dealer that could meet the criteria requiring disclosure as described in SOP 94-6 include a significant portion of revenue that is earned from the following:

- Bond underwritings to a particular municipality
- A limited number of customers

4.75 Concentrations, including known group concentrations, require disclosure if they meet the above criteria. (Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk.)

Disclosures About Derivative Instruments^{#,**}

4.76 FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*, FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, and FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, provides guidance on disclosure requirements for derivative instruments. FASB Statement No. 133 amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, to include in FASB Statement No. 107 the disclosure provisions about concentrations of credit risk from FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments With Concentrations of Credit Risk*, with certain modifications.

4.77 Freestanding written put options and certain contracts which function as market value guarantees on a financial asset that is owned by the guaranteed party, even when classified as derivatives under FASB Statement No. 133, are within the scope of the disclosure provisions of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. Under those provisions, guarantors are required to disclose the following:

- a. The nature of the guarantee, including its approximate term, how the guarantee arose, and the events and circumstances that would require the guarantor to perform under the guarantee.
- b. The undiscounted maximum potential amount of future payments the guarantor would be required to make under the guarantee, not reduced by any recourse or collateralization provisions.
- c. The current carrying amount of the liability, if any, for the guarantor's obligations under the guarantee.

[#] In February of 2006 the FASB issued FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*, which allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. Among other matters, FASB Statement No. 155 amends disclosure requirements of FASB Statement No. 133 to require:

- Separate display, either parenthetically or as a separate line on the face of the statement of financial condition, of amounts measured at fair value as a result of electing fair value measurement under FASB Statement No. 155
- Information that will allow users to understand the effect of changes in the fair value of hybrid financial instruments on earnings.

FASB Statement No. 155 is effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of FASB Statement No. 155 may also be applied upon its adoption for hybrid financial instruments that had been bifurcated under paragraph 12 of FASB Statement No. 133 prior to the adoption of FASB Statement No. 155. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period, for that fiscal year.

^{**} FASB has the Derivative Disclosures project on its agenda the objective of which is to provide guidance on enhanced disclosure requirements related to derivatives accounted for in accordance with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Additionally, the project is expected to reconsider the existing disclosure requirements under FASB Statement No. 133 for relevance and applicability. An exposure draft is expected to be issued in the 4th quarter of 2006.

- d. The nature of any recourse provisions that would enable the guarantor to recover any amounts paid under the guarantee from third parties and any assets held as collateral or by third parties that the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee, together with an indication, if estimable, of the approximate extent to which the maximum potential amount of future payments is covered by liquidating these assets.

Financial Statements and Schedules^{††}

4.78 The financial statements required to be filed under Rule 17a-5 are not required to be in comparative form, and the following financial statement exhibits are not prepared on that basis. However, if comparative financial statements are prepared, there is no need to present the supplementary information on a comparative basis.

4.79 The following financial statement and schedule exhibits include the required facing page and the oath or affirmation form on Form X-17A-5. These exhibits are illustrative only and have been prepared to show how various items might be presented, assuming they are material in the particular circumstances. The financial statements of individual companies may vary from these illustrations depending on facts or circumstances present at the time of issuance.

4.80 These illustrative financial statements have been updated to reflect accounting and reporting requirements of FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, and FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*.

^{††} 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, amends footnote 13 to Chapter 7 of the *Investment Companies Guide* to clarify that only investment partnerships regulated as brokers and dealers in securities under the Securities Exchange Act of 1934 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 but will have to follow the *Investment Companies Guide* which requires a schedule of investments and financial performance information.

Exhibit 4-1

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

ANNUAL AUDITED REPORT FORM X-17A-5 PART III	Information Required of Brokers and Dealers Pursuant to Section 17 of the Securities Exchange Act of 1934 and Rule 17a-5 Thereunder	<u>SEC FILE</u> 8-12345
------------------------------------------------------------	-------------------------------------------------------------------------------------------------------------------------------------------	----------------------------

REPORT FOR THE PERIOD BEGINNING	<u>01/01/X6</u> MM/DD/YY	AND ENDING	<u>12/31/X6</u> MM/DD/YY
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A. REGISTRANT IDENTIFICATION

NAME OF BROKER-DEALER:	<u>OFFICIAL USE ONLY</u>
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Standard Stockbrokerage Co., Inc.

ADDRESS OF PRINCIPAL PLACE OF BUSINESS: (Do not use P.O. Box No.)

1 Main Street

(No. and Street)

New York	New York	10004
(City)	(State)	(Zip Code)

NAME AND TELEPHONE NUMBER OF PERSON TO CONTACT IN REGARD TO THIS REPORT

Joseph P. Brokestock	(212) 555-1212
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(Area Code - Telephone No.)

B. ACCOUNTANT IDENTIFICATION

INDEPENDENT PUBLIC ACCOUNTANT (Whose opinion is contained in this Report*)
(Name . . . if individual, state last, first, middle name)

Accounting Firm

2 Main Street	New York	New York	10004
(Address)	(City)	(State)	(Zip Code)

CHECK ONE:

- Certified Public Accountant
- Public Accountant
- Accountant not resident in United States or any of its possessions.

FOR OFFICIAL USE ONLY

* *Claims for exemption from the requirement that the annual report be covered by the opinion of an independent public accountant must be supported by a statement of facts and circumstances relied on at the bureau of the exemption. See section 240.17a-5(e)(2).*

Exhibit 4-2

Oath or Affirmation

I, JOSEPH P. BROKESTOCK, swear (or affirm) that, to the best of my knowledge and belief, the accompanying financial statements and supporting schedules pertaining to the firm of STANDARD STOCKBROKERAGE CO., as of DECEMBER 31, 20 X6, are true and correct. I further swear (or affirm) that neither the Company nor any partner, proprietor, principal officer, or director has any proprietary interest in any account classified solely as that of a customer, except as follows:

SECURITY ACCOUNTS OF PRINCIPAL OFFICERS AND DIRECTORS THAT ARE CLASSIFIED AS CUSTOMER ACCOUNTS (DEBITS \$316,513, CREDITS \$273,412)

Signature

VICE PRESIDENT — FINANCE

Title

Subscribed and sworn
to before me
this ___ day of ___ 20X7

JOAN P. NOTARY
Notary Public

This report * contains (check all applicable boxes)

- (a) Facing page.
- (b) Statement of financial condition.
- (c) Statement of income (loss).
- (d) Statement of cash flows.
- (e) Statement of changes in stockholders' equity or partners' or sole proprietor's capital.
- (f) Statement of changes in liabilities subordinated to claims of general creditors.
- (g) Computation of net capital for brokers and dealers pursuant to Rule 15c3-1.
- (h) Computation for determination of reserve requirements pursuant to Rule 15c3-3.
- (i) Information relating to the possession or control requirements for brokers and dealers under Rule 15c3-3.
- (j) A reconciliation, including appropriate explanation, of the computation of net capital under Rule 15c3-1 and the computation for determination of the reserve requirements under exhibit A of Rule 15c3-3.
- (k) A reconciliation between the audited and unaudited statements of financial condition with respect to methods of consolidation.
- (l) An oath or affirmation.
- (m) A copy of the SIPC supplemental report.
- (n) A report describing any material inadequacies found to exist or found to have existed since the date of the previous audit.
- (o) Independent auditor's report on internal accounting control.⁸
- (p) Schedule of segregation requirements and funds in segregation—customers' regulated commodity futures account pursuant to Rule 171-5.

* For conditions of confidential treatment of certain portions of this filing, see section 240.17a-5(e)(3).

Note: Various exchanges may require an additional letter of attestation.

⁸ See Appendixes C and C-1, "Report on Internal Control Required by SEC Rule 17a-5," in this Audit and Accounting Guide.

Exhibit 4-3**Standard Stockbrokerage Co., Inc. and Subsidiaries****Consolidated Statement of Financial Condition****December 31, 20X6***(Dollars in Thousands, Except Share Data)***Assets**

Cash	\$ 2,647
Cash and securities segregated under federal and other regulations	1,005
Securities purchased under agreements to resell	6,282
Deposits with clearing organizations and others (cash of \$345 and securities with a market value of \$1,400)	1,745
Receivable from broker-dealers and clearing organizations	25,476
Receivable from customers [†]	40,360
Securities owned:	
Marketable, at market value (\$XXX pledged)*	29,738
Not readily marketable, at estimated fair value	1,730
Spot commodities owned, at market value (\$XXX pledged)*	3,278
Secured demand notes	5,215
Memberships in exchanges:	
Owned, at adjusted cost (market value \$2,500)	2,475
Furniture, equipment, and leasehold improvements, at cost, less accumulated depreciation and amortization of \$2,425	4,881
Other assets	<u>723</u>
	<u>\$125,555</u>

Brokers and Dealers in Securities
Liabilities and Stockholders' Equity

Liabilities:	
Short-term bank loans	\$ 26,900
Drafts payable	2,210
Securities sold under agreements to repurchase	5,790
Payable to broker-dealers and clearing organizations	19,164
Payable to customers	12,288
Securities sold, not yet purchased, at market value	1,862
Income taxes payable, including deferred taxes of \$1,200	2,276
Accounts payable, accrued expenses, and other liabilities	2,449
Long-term notes payable	<u>3,000</u>
	<u>75,939</u>
Commitments, contingencies and guarantees	
Subordinated borrowings	<u>9,897</u>
Stockholders' equity:	
Preferred stock, \$5 cumulative, \$100 par value, authorized 100,000 shares, outstanding 50,000 shares	5,000
Common stock, \$1 par value, authorized 10,000,000 shares, issued 6,000,000 shares	6,000
Additional paid-in capital	2,200
Retained earnings	27,719
Less 199,100 shares of common stock in treasury, at cost	<u>(1,200)</u>
Total stockholders' equity [†]	<u>39,719</u>
	<u>\$125,555</u>

The accompanying notes are an integral part of these financial statements.

* To the extent that collateral has been given and the counterparty has the right by contract or custom to sell or repledge the collateral, separate captions or parenthetical disclosures in the statement of financial condition may be needed as illustrated in FASB Statement No. 140.

† Valuation allowances should be shown, if material, either parenthetically or in a note.

‡ It is permissible, for the purpose of the separate report on the statement of financial condition (which is required to be distributed to customers), to present only the total of stockholders' equity (that is, \$39,719) without disclosure of the various components.

Exhibit 4-4**Standard Stockbrokerage Co., Inc. and Subsidiaries****Consolidated Statement of Income *****for the Year Ended December 31, 20X6***(Dollars in Thousands, Except Earnings per Share)*

Revenues	
Commissions	\$26,549
Principal transactions	6,707
Investment banking	5,689
Interest and dividends	4,253
Investment advisory fees	2,420
Other income	400
	<u>46,018</u>
Expenses:	
Employee compensation and benefits	12,815
Floor brokerage, exchange, and clearance fees	7,128
Communications and data processing	5,723
Interest and dividends	3,896
Occupancy	1,625
Other expenses	1,127
	<u>32,314</u>
Income before income taxes	13,704
Provision for income taxes	7,100
Net income	<u>\$ 6,604</u>
	<u>\$ 1.10</u>
Basic and diluted earnings per share †	

The accompanying notes are an integral part of these financial statements.

* FASB Statement No. 130, *Reporting Comprehensive Income*, establishes standards for the reporting and display of comprehensive income and its components. The Statement requires that all items that are required to be recognized under accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements. The Statement does not require a specific format for that financial statement but requires that an enterprise display an amount representing total comprehensive income for the period in that financial statement. The Statement does not apply to an enterprise that has no items of other comprehensive income in any period presented.

† FASB Statement No. 128, *Earnings per Share*, requires presentation of earnings per share by all entities that have issued common stock or potential common stock (that is, securities such as options, warrants, convertible securities, or contingent stock agreements) if those securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally. FASB Statement No. 128 also requires presentation of earnings per share by an entity that has made a

(continued)

filing or is in the process of filing with a regulatory agency in preparation for the sale of those securities in a public market.

In December 2003, FASB issued an exposure draft of a proposed statement entitled *Earnings per Share—an amendment of FASB Statement No. 128*. This proposed Statement would amend the computational guidance in FASB Statement No. 128, *Earnings per Share*, for calculating the number of incremental shares included in diluted shares when applying the treasury stock method. Also, this proposed Statement would eliminate the provisions of Statement 128 that allow an entity to rebut the presumption that contracts with the option of settling in either cash or stock will be settled in stock. In addition, this proposed Statement would require that shares that will be issued upon conversion of a mandatorily convertible security be included in the weighted average number of ordinary shares outstanding used in computing basic earnings per share from the date when conversion becomes mandatory. As the result of its redeliberations of the 2003 Exposure Draft, the FASB made additional changes to the requirements of FASB Statement No. 128 but has not made significant changes to the other issues addressed in that Exposure Draft. Therefore, a revised Exposure Draft that addresses the additional changes to the requirements of FASB Statement No. 128 was issued on September 30, 2005. The comment period ended on November 30, 2005.

In March 2004, the EITF reached a consensus on Issue No. 03-6, *Participating Securities and the Two Class Method Under FASB Statement No. 128*, Earnings Per Share, which addresses a number of questions regarding the computation of earnings per share by companies that have issued securities other than common stock that contractually entitle the holder to participate in dividends and earnings of the company. EITF No. 03-6 is effective for fiscal periods beginning after March 31, 2004 and requires retroactive adjustment of prior period earnings per share.

In September 2004, the EITF reached a consensus on Issue No. 04-8, *The Effect of Contingently Convertible Instruments on Diluted Earnings per Share*, which addresses when contingently convertible instruments should be included in diluted earnings per share. For purposes of this Issue, contingently convertible instruments are instruments that have embedded conversion features that are contingently convertible or exercisable based on (a) a market price trigger or (b) multiple contingencies if one of the contingencies is a market price trigger and the instrument can be converted or share settled based on meeting the specified market condition. A market price trigger is a market condition that is based at least in part on the issuer's own share price. Examples of contingently convertible instruments subject to this Issue include contingently convertible debt, contingently convertible preferred stock, and Instrument C in EITF Issue No. 90-19, *Convertible Bonds with Issuer Option to Settle for Cash upon Conversion*, all with embedded market price triggers. The guidance in EITF No. 04-8 should be applied to reporting periods ending after December 15, 2004 and prior-period diluted earnings per share should be restated.

Exhibit 4-5

Standard Stockbrokerage Co., Inc. and Subsidiaries
Consolidated Statement of Changes in Stockholders' Equity
for the Year Ended December 31, 20X6
(Dollars in Thousands, Except Share Data)

	Preferred		Common		Additional Paid-in Capital	Retained Earnings	Treasury Stock—Common		Total Stockholders' Equity
	Shares	Amount	Shares	Amount			Shares	Amount	
Balances at January 1, 20X6	52,500	\$5,250	6,000,000	\$6,000	\$2,212	\$21,365	195,700	\$(1,098)	\$33,729
Net Income						6,604			6,604
Purchase and retirement of preferred shares	(2,500)	(250)			(12)				(262)
Dividends on preferred stock \$5 a share						(250)			(250)
Net purchase of common shares for treasury							3,400	(102)	(102)
Balance at December 31, 20X6	<u>50,000</u>	<u>\$5,000</u>	<u>6,000,000</u>	<u>\$6,000</u>	<u>\$2,200</u>	<u>\$27,719</u>	<u>199,000</u>	<u>\$(1,200)</u>	<u>\$39,719</u>

The accompanying notes are an integral part of these financial statements.

Exhibit 4-6

Standard Stockbrokerage Co., Inc. and Subsidiaries
Consolidated Statement of Changes in Subordinated Borrowings
for the Year Ended December 31, 20X6
(Dollars in Thousands)

Subordinated borrowings at January 1, 20X6	\$ 4,204
Increases:	
Secured demand note collateral agreements	3,325
Issuance of subordinated notes	3,675
Decreases:	
Payment of subordinated notes	<u>(1,307)</u>
Subordinated borrowings at December 31, 20X6	<u>\$ 9,897</u>

The accompanying notes are an integral part of these financial statements.

Exhibit 4-7**Standard Stockbrokerage Co., Inc. and Subsidiaries****Consolidated Statement of Cash Flows
for the Year Ended December 31, 20X6***(Dollars in Thousands)*

Cash flows from operating activities:	
Net income	\$ 6,604
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	\$ 582
Deferred taxes	376
(Increase) decrease in operating assets:	
Cash and securities segregated under federal and other regulations	500
Deposits with clearing organizations and others	900
Net receivable from broker-dealers and clearing organizations	4,785
Net receivable from customers,	(11,830)
Securities purchased under agreements to resell*	2,648
Securities owned, net	4,655
Spot commodities owned	(2,914)
Increase (decrease) in operating liabilities:	
Securities sold under agreements to repurchase	587
Other, net	<u>(691)</u>
Total adjustments	<u>(402)</u>
Net cash provided by operating activities	<u>6,202</u>
Cash flows from investing activities:	
Proceeds from sale of long-term investments	110
Purchase of long-term investments	(50)
Purchase of furniture, equipment, and leasehold improvements	<u>(75)</u>
Net cash used in investing activities	<u>(15)</u>

(continued)

Cash flows from financing activities:	
Payment of short-term bank loans	(7,762)
Proceeds from issuance of derivatives with a financing element, net [†]	<u>100</u>
Proceeds from issuance of common stock from treasury	78
Purchase of common stock for treasury	(180)
Proceeds from issuance of subordinated notes	3,675
Payments of subordinated notes	(1,307)
Payments of long-term notes payable	(500)
Purchase and retirement of preferred stock	(262)
Dividend on preferred stock	<u>(250)</u>
Net cash used in financing activities	<u>(6,408)</u>
Decrease in cash	(221)
Cash at beginning of the year	<u>2,868</u>
Cash at end of the year	<u><u>\$ 2,647</u></u>
Supplemental cash flows disclosures:	
Income tax payments (paid to parent)	<u>\$ 6,700</u>
Interest payments	<u>\$ 3,618</u>
Noncash financing activity—borrowings under secured demand note collateral agreements	<u><u>\$ 3,325</u></u>

The accompanying notes are an integral part of these financial statements.

* Depending on the nature of the activity, securities purchased under agreements to resell can be classified as operating or investing; likewise, securities sold under agreements to repurchase can be classified as operating or financing.

[†] FASB Statement No. 133, as amended, requires all cash flows associated with a derivative that contains an other-than-insignificant financing element at inception, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments (that is, the forward points in an at-the-money forward contract), to be reported as cash flows from financing activities in the statement of cash flows as opposed to reporting only the cash flows related to a financing element of a derivative as a financing activity.

Exhibit 4-8**Standard Stockbrokerage Co., Inc. and Subsidiaries****Notes to Consolidated Financial Statements****December 31, 20X6***(Dollars in Thousands)*

The following notes to financial statements are illustrative only. In some situations, the information in the notes may be better presented within the financial statements; in other situations, information not required by regulation may not be sufficiently material to warrant disclosure. In addition, these notes may not include all disclosures required by Regulation S-X.⁹

1. Organization and Nature of Business

The Company is a broker-dealer registered with the Securities and Exchange Commission (SEC) and is a member of various exchanges and the National Association of Securities Dealers (NASD). The Company is a Delaware Corporation that is a wholly-owned subsidiary of Standard Stockbrokerage Holding Company, Inc. (Parent).

2. Significant Accounting Policies*Basis of Presentation*

The consolidated financial statements include the accounts of the Company and its wholly-owned and majority-owned subsidiaries. The Company is engaged in a single line of business as a securities broker-dealer, which comprises several classes of services, including principal transactions, agency transactions, investment banking, investment advisory, and venture capital businesses. All material intercompany balances and transactions are eliminated in consolidation.

Securities Transactions

Proprietary securities transactions in regular-way trades are recorded on the trade date, as if they had settled. Profit and loss arising from all securities and commodities transactions entered into for the account and risk of the Company are recorded on a trade date basis. Customers' securities and commodities transactions are reported on a settlement date basis with related commission income and expenses reported on a trade date basis.¹⁰

Amounts receivable and payable for securities transactions that have not reached their contractual settlement date are recorded net on the statement of financial condition.

Marketable securities are valued at market value, and securities not readily marketable are valued at fair value as determined by management.

⁹ A discussion of the disclosures required by SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, is included in paragraphs 4.66 through 4.75 in this Guide.

¹⁰ See Chapter 7, "Accounting Standards," of the Guide regarding settlement-date-basis versus trade-date-basis accounting.

Resale and Repurchase Agreements

Transactions involving purchases of securities under agreements to resell (reverse repurchase agreements or reverse repos) or sales of securities under agreements to repurchase (repurchase agreements or repos) are accounted for as collateralized financings except where the Company does not have an agreement to sell (or purchase) the same or substantially the same securities before maturity at a fixed or determinable price. It is the policy of the Company and subsidiaries to obtain possession of collateral with a market value equal to or in excess of the principal amount loaned under resale agreements. Collateral is valued daily, and the Company may require counterparties to deposit additional collateral or return collateral pledged when appropriate.

Securities-Lending Activities

Securities borrowed and securities loaned transactions are generally reported as collateralized financings except where letters of credit or other securities are used as collateral. Securities-borrowed transactions require the Company to deposit cash, letters of credit, or other collateral with the lender. With respect to securities loaned, the Company receives collateral in the form of cash or other collateral in an amount generally in excess of the market value of securities loaned. The Company monitors the market value of securities borrowed and loaned on a daily basis, with additional collateral obtained or refunded as necessary.

Collateral

The Company continues to report assets it has pledged as collateral in secured borrowing and other arrangements when the secured party cannot sell or repledge the assets.

Investment Banking

Investment banking revenues include gains, losses, and fees, net of syndicate expenses, arising from securities offerings in which the Company acts as an underwriter or agent. Investment banking revenues also include fees earned from providing merger-and-acquisition and financial restructuring advisory services. Investment banking management fees are recorded on offering date, sales concessions on settlement date, and underwriting fees at the time the underwriting is completed and the income is reasonably determinable.

Commissions

Commissions and related clearing expenses are recorded on a trade-date basis as securities transactions occur.

Investment Advisory Income

Investment advisory fees are received quarterly but are recognized as earned on a pro rata basis over the term of the contract.

Translation of Foreign Currencies

Assets and liabilities denominated in foreign currencies are translated at year-end rates of exchange, while the income statement accounts are translated at average rates of exchange for the year. Gains or losses resulting from foreign currency transactions are included in net income.

Income Taxes

The Company and its subsidiaries are included in the consolidated federal income tax return filed by the Parent. Federal income taxes are calculated as if the companies filed on a separate return basis, and the amount of current tax or benefit calculated is either remitted to or received from the Parent. The amount of current and deferred taxes payable or refundable is recognized as of the date of the financial statements, utilizing currently enacted tax laws and rates. Deferred tax expenses or benefits are recognized in the financial statements for the changes in deferred tax liabilities or assets between years.

Depreciation

Depreciation is provided on a straight-line basis using estimated useful lives of five to ten years. Leasehold improvements are amortized over the lesser of the economic useful life of the improvement or the term of the lease.

Drafts Payable

Drafts payable represent amounts drawn by the Company against a bank and sight overdrafts under a sweep agreement with a bank.

Exchange Memberships

The Company's exchange memberships, which represent ownership interests in the exchanges and provide the Company with the right to conduct business on the exchanges, are recorded at cost or, if an other than temporary impairment in value has occurred, at a value that reflects management's estimate of the impairment. Management believes that such impairment in value occurred in 20X5, at which time the Company wrote down the cost of its exchange memberships. There were no exchange membership impairments in 20X6.

Statement of Cash Flows

For purposes of the Consolidated Statement of Cash Flows, the Company has defined cash equivalents as highly liquid investments, with original maturities of less than ninety days, that are not held for sale in the ordinary course of business.

3. Cash and Securities Segregated Under Federal and Other Regulations

Cash of \$275 and U.S. Treasury bills with a market value of \$630 are segregated under the Commodity Exchange Act and represent funds deposited by customers and funds accruing to customers as a result of trades or contracts.

Cash of \$100 has been segregated in a special reserve bank account for the benefit of customers under Rule 15c3-3 of the Securities and Exchange Commission.¹¹

¹¹ This is possible wording for those situations in which a deposit is required based on SEC Rule 15c3-3 computation.

4. Receivable From and Payable to Broker-Dealers and Clearing Organizations

Amounts receivable from and payable to broker-dealers and clearing organizations at December 31, 20X6, consist of the following:

	<u>Receivable</u>	<u>Payable</u>
Deposits for securities borrowed/loaned	\$ 7,756	\$ 7,395
Securities failed-to-deliver/receive	13,646	1,014
Payable to clearing broker	—	9,350
Receivable from clearing organizations	2,173	—
Fees and commissions receivable/payable	1,312	1,196
Other	589	209
	<u>\$25,476</u>	<u>\$19,164</u>

The Company clears certain of its proprietary and customer transactions through another broker-dealer on a fully disclosed basis. The amount payable to the clearing broker relates to the aforementioned transactions and is collateralized by securities owned by the Company.

5. Receivable From and Payable to Customers

Accounts receivable from and payable to customers include amounts due on cash and margin transactions. Securities owned by customers are held as collateral for receivables.

6. Securities Owned and Sold, Not Yet Purchased

Marketable securities owned and sold, not yet purchased, consist of trading and investment securities at market values, as follows:

	<u>Owned</u>	<u>Sold, Not Yet Purchased</u>
Obligations of U.S. government	\$15,400	
State and municipal obligations	608	
Corporate bonds, debentures, and notes	6,900	
Corporate stocks	5,930	\$1,190
Options and warrants	900	672
	<u>\$29,738</u>	<u>\$1,862</u>

Securities not readily marketable include investment securities (a) for which there is no market on a securities exchange or no independent publicly quoted market, (b) that cannot be publicly offered or sold unless registration has been effected under the Securities Act of 1933, or (c) that cannot be offered or sold because of other arrangements, restrictions, or conditions applicable to the securities or to the Company.

At December 31, 20X6, these securities carried at estimated fair values consist of the following:

Bonds	\$ 851
Equities	692
Options	187
	<u>\$1,730</u>

7. Bank Loans

Customer loans of \$18,400 are collateralized by \$24,000 of customers' margin account securities, and firm loans of \$8,500 are collateralized by \$14,800 of securities owned by the Company and \$3,000 of securities held pursuant to secured demand note collateral agreements.

8. Long-Term Notes Payable

The long-term notes payable of \$3,000 bear interest at 10.5 percent and are payable in semiannual installments of \$250 through July 1, 20Y2. Furniture and equipment with a net carrying value of \$2,500 has been pledged as sole recourse to secure the notes.

9. Subordinated Borrowings¹²

The borrowings under subordination agreements at December 31, 20X6, are listed in the following:

Subordinated notes, 10 percent, due December 31, 20X8	\$4,307
Secured demand note collateral agreements, 6 percent, due \$1,000 in March 20X7, \$1,200 in March 20X8, and \$3,015 in December 20X8	5,215
Exchange memberships contributed for the use of the Company	<u>375</u>
	<u>\$9,897</u>

The subordinated borrowings are available in computing net capital under the SEC's uniform net capital rule. To the extent that such borrowings are required for the Company's continued compliance with minimum net capital requirements, they may not be repaid. It is the Company's intention not to renew the secured demand note collateralizing agreements due on March 20X7.¹³

The carrying amount of subordinated borrowings approximates fair value due to borrowings at market rate.

10. Preferred Stock

The preferred stock is redeemable at the option of the Company at \$105 a share. There are no calls or puts on the preferred stock.

11. Pension and Other Postretirement Benefit Plans¹⁴

The Company has a qualified, noncontributory defined-benefit retirement plan covering substantially all of its employees. The benefits are based on each employee's years of service up to a maximum of twenty-five years, and the average of the highest five consecutive annual salaries of the ten years prior to retirement. The benefits are reduced by a specified percentage of the employee's

¹² Significant restrictive covenants of debt agreements should be disclosed.

¹³ Because of the unique characteristics of subordinated borrowings, additional disclosure of the amount for which six months' notice has been given of intent to withdraw is necessary.

¹⁴ The disclosures for pensions and other postretirement benefits in this note to the illustrative financial statements are based on the requirements of FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits* (revised 2003). This note to the financial statements illustrates the reduced disclosures about pension and postretirement benefit plans for a nonpublic entity. Readers should refer to FASB Statement No. 132 (revised 2003) when considering disclosure requirements for public entities.

(continued)

social security benefit. An employee becomes fully vested upon completion of five years of qualifying service. It is the policy of the Company to fund the maximum amount that can be deducted for federal income tax purposes.

The Company provides health and life insurance benefits to retired employees. The health care component is contributory, with retiree contributions adjusted periodically. The life insurance component is noncontributory. The accounting for health care anticipates future changes in cost-sharing provisions. The Company reserves the right to amend or terminate these programs at any time. Full-time employees of the Company become eligible for these benefits upon attainment of age 55 and completion of ten years of service.

The company uses a December 31 measurement date for its plans.

	<i>Pension Benefits 20X6</i>	<i>Other Benefits 20X6</i>
Benefit cost	\$ 254	\$ 443
Employer contribution	250	
Plan participants' contributions		10
Benefits paid	(125)	(30)
Benefit obligation at December 31	\$4,003	\$ 1,401
Fair value of plan assets at December 31	<u>4,297</u>	<u>0</u>
Funded status	<u>\$ 294</u>	<u>\$(1,401)</u>
Net amount recognized	\$ 264	\$(1,401)

Amounts recognized in the statement of financial condition consist of:

	<i>Pension Benefits 20X6</i>	<i>Other Benefits 20X6</i>
Prepaid benefit cost	<u>\$264</u>	\$ 0
Accrued benefit cost	<u>0</u>	<u>(1,401)</u>
Funded status	<u>\$264</u>	<u>\$(1,401)</u>

The accumulated benefit obligation for defined benefit pension plan was \$XXX at December 31, 20X6.

(footnote continued)

On September 29, 2006, the FASB issued FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*. FASB Statement No. 158 requires an employer to:

- Recognize in its statement of financial position an asset for a plan's overfunded status or a liability for a plan's underfunded status
- Measure a plan's assets and its obligations that determine its funded status as of the end of the employer's fiscal year (with limited exceptions)
- Recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. Those changes will be reported in comprehensive income of a business entity and in changes in net assets of a not-for-profit organization.

FASB Statement No. 158 applies to plan sponsors that are public and private companies and non-governmental not-for-profit organizations. The requirement to recognize the funded status of a benefit plan and the disclosure requirements are effective as of the end of the fiscal year ending after December 15, 2006, for entities with publicly traded equity securities, and at the end of the fiscal year ending after June 15, 2007, for all other entities. The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008.

Additional Information

Assumptions

Weighted-average assumptions used to determine benefit obligations at December 31, 20X6:

	<u>Pension Benefits</u>	<u>Other Benefits</u>
Discount rate	8.00%	8.00%
Rate of compensation increase	5.50%	

Weighted-average assumptions used to determine net periodic benefit cost for the year ended December 31, 20X6:

	<u>Pension Benefits</u>	<u>Other Benefits</u>
Discount rate	8.00%	8.00%
Expected return on plan assets	6.50%	
Rate of compensation increase	5.50%	

[Entity-specific narrative description of the basis used to determine the overall expected long-term rate of return on assets, as described in paragraph 8(c)(3) of FASB Statement No. 132 (revised 2003) would be included here.]

Assumed health care cost trend rates at December 31, 20X6

Different health care cost trend rates were assumed for coverage to age 65.

	<u>Pre-65</u>	<u>Post-65</u>
Health care cost trend rate assumed for next year	14%	11%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	7%	5%
Year that the rate reaches the ultimate trend rate	20XX	20XX

Plan Assets

The Company's pension plan weighted-average asset allocations as of December 31, 20X6, by asset category are as follows:

<u>Asset Category</u>	<u>Plan Assets at December 31, 20X6</u>
Equity securities	XX%
Debt securities	XX
Real estate	XX
Other	XX
Total	<u>100%</u>

[Entity specific narrative description of investment policies and strategies for plan assets, including weighted-average target asset allocations [if used as part of those policies and strategies] as described in paragraph 8(c)(2) of FASB Statement No. 132 (revised 2003) would be included here. According to paragraph 8(c)(4), disclosure of additional asset categories and additional information about specific assets within a category is encouraged if that information

is expected to be useful in understanding the risks associated with each asset category and the overall expected long-term rate of return on assets.]

Cash Flows

Contributions

The Company expects to contribute \$XXX to its pension plan and \$XXX to its other postretirement benefit plan in 20X7.

Estimated Future Benefit Payments

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

	<u>Pension Benefits</u>	<u>Other Benefits</u>
20X7	\$XXX	\$XXX
20X8	\$XXX	\$XXX
20X9	\$XXX	\$XXX
20Y0	\$XXX	\$XXX
20Y1	\$XXX	\$XXX
Years 20Y2–20Y6	\$XXX	\$XXX

12. Financial Instruments^{††, †††}

Accounting Policies

Derivative financial instruments used for trading purposes, including economic hedges of trading instruments, are carried at market value or, if market prices are not readily available, fair value. Market values for exchange-traded derivatives, principally futures and certain options, are based on quoted market prices. Fair values for over-the-counter derivative financial instruments, principally forwards, options, and swaps, are based on pricing models intended to approximate the amounts that would be received from or paid to a third party in settlement of the contracts. Factors taken into consideration in estimating fair value of over-the-counter derivatives include credit spreads, market liquidity, concentrations, and funding and administrative costs incurred over the life of the instruments.

^{††} On September 15, 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, that provides enhanced guidance for using fair value to measure assets and liabilities. Among other matters, FASB Statement No. 157 nullifies the guidance in footnote 3 of 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," which applied for derivatives (and other) instruments measured at fair value at initial recognition under FASB Statement No. 133. That guidance precluded immediate recognition in earnings of an unrealized gain or loss, measured as the difference between the transaction price and the fair value of the instrument at initial recognition, if the fair value of the instrument was determined using significant unobservable inputs. FASB Statement No. 157 also expands disclosures about the use of fair value to measure assets and liabilities in interim and annual periods subsequent to initial recognition.

See footnote * immediately preceding paragraph 7.02 for a discussion of other provisions of FASB Statement No. 157 that may be of interest to broker-dealers and their auditors. See FASB Web site at www.fasb.org for full text of FASB Statement No. 157.

^{†††} In February of 2006 the FASB issued FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*, which allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. Among other matters, FASB Statement No. 155 amends disclosure requirements of FASB Statement No. 133. For more information on FASB Statement No. 155 please refer to footnote # to the "Disclosures About Derivative Instruments" section of this chapter.

Derivatives used for economic hedging purposes include swaps, forwards, futures, and purchased options. Unrealized gains or losses on these derivative contracts are recognized currently in the statement of income as trading revenues. The Company does not apply hedge accounting as defined in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, as all financial instruments are marked to market with changes in fair values reflected in earnings. Therefore, the disclosures required in paragraphs 44 and 45 of the Statement are generally not applicable with respect to these financial instruments.

Fair values of forwards, swaps, and options contracts are recorded in securities owned or securities sold, not yet purchased, as appropriate. Open equity in futures transactions are recorded as receivables from and payables to broker-dealers and clearing organizations or customers, as applicable.

Premiums and unrealized gains and losses for written and purchased option contracts, as well as unrealized gains and losses on interest rate swaps, are recognized gross in the consolidated statement of financial condition. The unrealized gains for delayed-delivery, to-be-announced (TBA), and when-issued securities generally are recorded in the consolidated statement of financial condition net of unrealized losses by counterparty where master netting agreements are in place.

Principal Transactions (Disclosure is not required by FASB Statement No. 133, as amended; however, it is a recommended disclosure for the Broker-Dealer Industry)

The Company's principal transaction revenues by reporting categories, including derivatives, at December 31, 20X6, are the following:

Fixed income	\$2.6
Equity	3.5
Foreign exchange and other derivative financial instruments	<u>0.6</u>
	<u>\$6.7</u>

Fair Value of Financial Instruments^{##} (Disclosure is not required by FASB Statement No. 133, as amended; however, this disclosure was encouraged for SEC registrants in a letter from Lynn Turner, Chief Accountant for the SEC, to the AICPA in October 2000)

^{##} FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities—an amendment to FASB Statement No. 107*, as amended by FASB Statements No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, to make the disclosures about fair value of financial instruments prescribed in FASB Statement No. 107 optional for entities that meet all of the following criteria:

- a. The entity is a nonpublic entity.
- b. The entity's total assets are less than \$100 million on the date of the financial statements.
- c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB Statement No. 133, other than commitments related to the origination of mortgage loans to be held for sale, during the reporting period.

The financial instruments of the Company are reported in the consolidated statement of financial condition at market or fair values, or at carrying amounts that approximate fair values because of the short maturity of the instruments, except repurchase and reverse repurchase agreements, long-term notes payable, and subordinated borrowings. The estimated fair values of these financial instruments at December 31, 20X6, are as follows:¹⁵

	<i>Assets (Liabilities)</i>	
	<i>Carrying Amount</i>	<i>Fair Value</i>
Repurchase agreements	\$(5,790)	\$ (5,778)
Reverse repurchase agreements	6,282	6,296
Long-term notes payable	(3,000)	(3,300)
Subordinated borrowings	(9,897)	(10,800)

The fair value estimates of repurchase and reverse repurchase agreements are based on dealer quotes. The fair value estimates of the Company's long-term notes payable and subordinated borrowings are based on current rates offered to the Company for debt with substantially the same characteristics and maturities.

Financial Instruments With Off-Balance-Sheet Risk

The Company enters into various transactions involving derivatives and other off-balance sheet financial instruments. These financial instruments include futures, forward and foreign exchange contracts, exchange-traded and over-the-counter options, delayed deliveries, mortgage-backed to-be-announced securities (TBAs), securities purchased and sold on a when-issued basis (when-issued securities), and interest rate swaps. These derivative financial instruments are used to meet the needs of customers, conduct trading activities, and manage market risks and are, therefore, subject to varying degrees of market and credit risk. Derivative transactions are entered into for trading purposes or to economically hedge other positions or transactions.

Futures and forward contracts and TBAs and when-issued securities provide for the delayed delivery of the underlying instrument. As a writer of options, the Company receives a premium in exchange for giving the counterparty the right to buy or sell the security at a future date at a contracted price. Interest rate swaps involve the exchange of payments based on fixed or floating rates applied to notional amounts. The contractual or notional amounts related to these financial instruments reflect the volume and activity and do not reflect the amounts at risk. Futures contracts are executed on an exchange, and cash settlement is made on a daily basis for market movements. Accordingly, futures contracts generally do not have credit risk. The credit risk for forward contracts, TBAs, options, swaps, and when-issued securities is limited to the unrealized market valuation gains recorded in the statement of financial condition. Market risk is substantially dependent upon the value of the underlying financial instruments and is affected by market forces such as volatility and changes in interest and foreign exchange rates.

The Company had certain other transactions which, in accordance with industry practice, were not recorded on the statement of financial condition. At

¹⁵ When carrying amounts and fair values are the same, the table may be omitted if that is stated.

December 31, 20X6, the Company had commitments to enter into future resale and repurchase agreements. At December 31, 20X6, the Company had also borrowed securities and pledged securities against those borrowed securities.

In addition, the Company has sold securities that it does not currently own and will therefore be obligated to purchase such securities at a future date. The Company has recorded these obligations in the financial statements at December 31, 20X6, at market values of the related securities and will incur a loss if the market value of the securities increases subsequent to December 31, 20X6.

In the normal course of business, the Company's customer activities involve the execution, settlement, and financing of various customer securities transactions. These activities may expose the Company to off-balance-sheet risk in the event the customer or other broker is unable to fulfill its contracted obligations and the Company has to purchase or sell the financial instrument underlying the contract at a loss.

The Company's customer securities activities are transacted on either a cash or margin basis. In margin transactions, the Company extends credit to its customers, subject to various regulatory and internal margin requirements, collateralized by cash and securities in the customers' accounts. In connection with these activities, the Company executes and clears customer transactions involving the sale of securities not yet purchased, substantially all of which are transacted on a margin basis subject to individual exchange regulations. Such transactions may expose the Company to significant off-balance-sheet risk in the event margin requirements are not sufficient to fully cover losses that customers may incur. In the event the customer fails to satisfy its obligations, the Company may be required to purchase or sell financial instruments at prevailing market prices to fulfill the customer's obligations. The Company seeks to control the risks associated with its customer activities by requiring customers to maintain margin collateral in compliance with various regulatory and internal guidelines. The Company monitors required margin levels daily and, pursuant to such guidelines, requires the customer to deposit additional collateral or to reduce positions when necessary.

The Company's customer financing and securities settlement activities require the Company to pledge customer securities as collateral in support of various secured financing sources such as bank loans and securities loaned. In the event the counterparty is unable to meet its contractual obligation to return customer securities pledged as collateral, the Company may be exposed to the risk of acquiring the securities at prevailing market prices in order to satisfy its customer obligations. The Company controls this risk by monitoring the market value of securities pledged on a daily basis and by requiring adjustments of collateral levels in the event of excess market exposure. In addition, the Company establishes credit limits for such activities and monitors compliance on a daily basis.

Quantitative Disclosures for Derivative Financial Instruments Used for Trading Purposes (Disclosure is not required by FASB Statement No. 133, as amended; however, it is a recommended disclosure for the Broker-Dealer Industry)

As of December 31, 20X6, the gross contractual or notional amounts of derivative financial instruments used for trading purposes are as follows:

	<i>Notional or Contract Amount</i>
Interest Rate:	
Swap agreements, including options, swaptions, caps, collars, and floors	\$50
Futures contracts	5
Options held	2
Foreign Exchange:	
Futures contracts	5
Forward contracts	23
Options held	1
Options written	2
Mortgage-Backed Securities:	
Forward contracts	10
Equity:	
Swap agreements	22
Futures contracts	5
Options held	1
Options written	1

The majority of the Company's transactions with off-balance-sheet risk are short-term in duration with a weighted average maturity of approximately 1.65 years at December 31, 20X6. The remaining maturities for notional or contract amounts outstanding for derivative financial instruments are as follows:¹⁶

	<i>Less than One year</i>	<i>One to Three Years</i>	<i>Three to Five Years</i>	<i>Greater than 5 years</i>	<i>Total</i>
Swap agreements	\$ 20	\$ 25	\$ 16	\$ 11	\$ 72
Futures contracts	9	5	1		15
Forward contracts	33				33
Options held	4				4
Options written	3				3
Total	<u>\$ 69</u>	<u>\$ 30</u>	<u>\$ 17</u>	<u>\$ 11</u>	<u>\$ 127</u>
Percent of total	<u>54%</u>	<u>24%</u>	<u>13%</u>	<u>9%</u>	<u>100%</u>

The fair values of derivative financial instruments held or issued for trading purposes as of December 31, 20X6, and the average monthly fair value of the instruments for the year ended December 31, 20X6, are as follows:

	<i>Fair Value at Year-End</i>		<i>Average Fair Values</i>	
	<i>Assets</i>	<i>Liabilities</i>	<i>Assets</i>	<i>Liabilities</i>
Swap agreements	\$48.7	\$39.2	\$49.8	\$29.8
Forward contracts	10.9	8.1	3.1	2.0
Options held	32.7		20.3	
Options written	—	38.3	—	16.2
Total	<u>\$92.3</u>	<u>\$85.6</u>	<u>\$73.2</u>	<u>\$48.0</u>

¹⁶ The disclosure of the remaining maturities for notional or contract amounts for derivative financial instruments is encouraged, but not required.

The following table summarizes the credit quality of the Company's trading-related derivatives by showing counterparty credit ratings for the replacement cost (net of collateral of \$30.3 million) of contracts in a gain position at December 31, 20X6.¹⁷

<u>Rating*</u>	<u>Net Replacement Cost</u>
AAA	\$12
AA	22
A	13
BBB and lower	10
Other†	5

* Rating Agency Equivalent

† "Other" indicates counterparties for which no credit was available from an independent third-party source. It does not necessarily indicate the counterparties credit is below investment grade.

Derivative Financial Instruments Used for Purposes Other Than Trading

The Company enters into derivative contracts to economically hedge exposures or to modify the characteristics of financial instruments or transactions.

Open derivative contracts, which are linked to assets or liabilities that are sold or otherwise disposed of, are terminated at the time of disposition. Unrealized gains or losses on such derivative contracts are recognized in the statement of income currently as trading revenues.

(Disclosure in this paragraph is not required by FASB Statement No. 133, as amended; however, it is a recommended disclosure for the Broker-Dealer Industry). At December 31, 20X6, the Company had outstanding interest rate and currency swap agreements with a notional principal amount of \$800. The swaps are recorded at fair value, and changes in fair value are included in income currently. Additionally, periodic settlements paid or received are included in income currently.

Concentrations of Credit Risk

The Company and its subsidiaries are engaged in various trading and brokerage activities in which counterparties primarily include broker-dealers, banks, and other financial institutions. In the event counterparties do not fulfill their obligations, the Company may be exposed to risk. The risk of default depends on the creditworthiness of the counterparty or issuer of the instrument. It is the Company's policy to review, as necessary, the credit standing of each counterparty.

13. Commitments and Contingent Liabilities

The Company is contingently liable as of December 31, 20X6, in the amount of \$4,375 under bank guarantees and has outstanding letter-of-credit agreements aggregating \$3,000 used in lieu of margin deposits. The Company has determined that these commitments do not meet the definition of a derivative,

¹⁷ Quantitative disclosure for derivative financial instruments such as this table is encouraged, but not required.

as defined by FASB Statement No. 133, as amended. These agreements are generally made for periods of six months to one year and bear interest at rates from .5 percent to 1 percent.

The Company and its subsidiaries have obligations under operating leases with initial noncancelable terms in excess of one year. Aggregate annual rentals for office space and equipment at December 31, 20X6, are approximately as listed below:

20X7	\$1,492
20X8	1,440
20X9	1,006
20Y0	982
20Y1	901
Later years	<u>1,164</u>
	<u>\$6,985</u>

Certain leases contain renewal options and escalation clauses. Rent expense for 20X6 aggregated to \$1,519 and is included in the *Occupancy* expense line item on the Consolidated Statement of Income.

The Company and a subsidiary—together with various other broker-dealers, corporations, and individuals—have been named as defendants in several class action lawsuits that allege violations of federal and state securities laws and claim substantial damages. The Company is also a defendant in other lawsuits incidental to its securities and commodities business. Management of the Company, after consultation with outside legal counsel, believes that the resolution of these various lawsuits will not result in any material adverse effect on the Company's consolidated financial position.

In the normal course of business, the Company enters into underwriting commitments. Transactions relating to such underwriting commitments that were open at December 31, 20X6, and were subsequently settled had no material effect on the financial statements as of that date.

14. Guarantees

FASB Interpretation No. 45 (FIN 45), *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, requires the Company to disclose information about its obligations under certain guarantee arrangements. FIN 45 defines guarantees as contracts and indemnification agreements that contingently require a guarantor to make payments to the guaranteed party based on changes in an underlying (such as an interest or foreign exchange rate, security or commodity price, an index or the occurrence or nonoccurrence of a specified event) related to an asset, liability or equity security of a guaranteed party. FIN 45 also defines guarantees as contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an agreement as well as indirect guarantees of the indebtedness of others.

Derivative Contracts

Certain derivative contracts that the Company has entered into meet the accounting definition of a guarantee under FIN 45. Derivatives that meet the FIN 45 definition of guarantees include certain written options and credit default swaps. Since the Company does not track the counterparties' purpose for entering into a derivative contract, it has disclosed derivative contracts that

are likely to be used to protect against a change in an underlying financial instrument, regardless of their actual use.

The maximum potential payout for certain derivative contracts, such as written interest rate caps and written foreign currency options, cannot be estimated as increases in interest or foreign exchange rates in the future could possibly be unlimited. Therefore, in order to provide information regarding the maximum potential amount of future payments that the Company could be required to make under certain derivative contracts, the notional amount of the contracts has been disclosed.

The Company records all derivative contracts at fair value. For this reason, the Company does not monitor its risk exposure to derivative contracts based on derivative notional amounts; rather the Company manages its risk exposure on a fair value basis. Aggregate market risk limits have been established, and market risk measures are routinely monitored against these limits. The Company also manages its exposure to these derivative contracts through a variety of risk mitigation strategies, including, but not limited to, entering into offsetting economic hedge positions. The Company believes that the notional amounts of the derivative contracts generally overstate its exposure.

Indemnifications

In the normal course of its business, the Company indemnifies and guarantees certain service providers, such as clearing and custody agents, trustees and administrators, against specified potential losses in connection with their acting as an agent of, or providing services to, the Company or its affiliates. The Company also indemnifies some clients against potential losses incurred in the event specified third-party service providers, including subcustodians and third-party brokers, improperly execute transactions. The maximum potential amount of future payments that the Company could be required to make under these indemnifications cannot be estimated. However, the Company believes that it is unlikely it will have to make material payments under these arrangements and has not recorded any contingent liability in the consolidated financial statements for these indemnifications.

The Company provides representations and warranties to counterparties in connection with a variety of commercial transactions and occasionally indemnifies them against potential losses caused by the breach of those representations and warranties. The Company may also provide standard indemnifications to some counterparties to protect them in the event additional taxes are owed or payments are withheld, due either to a change in or adverse application of certain tax laws. These indemnifications generally are standard contractual terms and are entered into in the normal course of business. The maximum potential amount of future payments that the Company could be required to make under these indemnifications cannot be estimated. However, the Company believes that it is unlikely it will have to make material payments under these arrangements and has not recorded any contingent liability in the consolidated financial statements for these indemnifications.

Exchange Member Guarantees

The Company is a member of various exchanges that trade and clear securities and/or futures contracts. Associated with its membership, the Company may be required to pay a proportionate share of the financial obligations of another member who may default on its obligations to the exchange. While the rules governing different exchange memberships vary, in general the Company's

guarantee obligations would arise only if the exchange had previously exhausted its resources. In addition, any such guarantee obligation would be apportioned among the other non-defaulting members of the exchange. Any potential contingent liability under these membership agreements cannot be estimated. The Company has not recorded any contingent liability in the consolidated financial statements for these agreements and believes that any potential requirement to make payments under these agreements is remote.

Other Guarantees

The Company, in its capacity as an agency lender, occasionally indemnifies securities lending customers against losses incurred in the event that borrowers do not return securities and the collateral held is insufficient to cover the market value of the securities borrowed. In addition, the Company provides letters of credit and other guarantees, on a limited basis, to enable clients to enhance their credit standing and complete transactions.

The following table sets forth the maximum payout/notional amounts associated with the Company's guarantees as of December 31, 20X6:

Maximum Potential Payout/Notional

Years to Maturity

<u>Type of Guarantee</u>	<u>Less than 1</u>	<u>1-3</u>	<u>3-5</u>	<u>Over 5</u>	<u>Total</u>	<u>Carrying Amount</u>	<u>Collateral/ Recourse</u>
	<i>(dollars in thousands)</i>						
Derivative contracts	<u>\$XX</u>	<u>\$XX</u>	<u>\$XX</u>	<u>\$XX</u>	<u>\$XX</u>	<u>\$XX</u>	<u>\$XX</u>
Securities lending indemnifications	<u>\$XX</u>	<u>\$XX</u>	<u>\$XX</u>	<u>\$XX</u>	<u>\$XX</u>	<u>\$XX</u>	<u>\$XX</u>
Letters of credit and other guarantees	<u>\$XX</u>	<u>\$XX</u>	<u>\$XX</u>	<u>\$XX</u>	<u>\$XX</u>	<u>\$XX</u>	<u>\$XX</u>

15. Net Capital Requirements

The Company is subject to the Securities and Exchange Commission Uniform Net Capital Rule (SEC Rule 15c3-1), which requires the maintenance of minimum net capital and requires that the ratio of aggregate indebtedness to net capital, both as defined, shall not exceed 15 to 1 (and the rule of the "applicable" exchange also provides that equity capital may not be withdrawn or cash dividends paid if the resulting net capital ratio would exceed 10 to 1).¹⁸ The Company is also subject to the Commodity Futures Trading Commission's (CFTC's) minimum financial requirements (Regulation 1.17), which require that the Company maintain net capital, as defined, equal to 4 percent of customer funds required to be segregated pursuant to the Commodity Exchange Act, less the market value of certain commodity options, all as defined.¹⁹ At December 31, 20X6, the Company had net capital of \$33,584, which was \$29,381 in excess of its required net capital of \$4,203. The Company's net capital ratio was 1.7 to 1.²⁰

¹⁸ Various regulatory agencies and exchanges may impose additional capital requirements, which may be necessary to disclose.

¹⁹ Only applicable if the broker-dealer is a futures commission merchant subject to Regulation 1.17 of the CFTC.

²⁰ See illustrative Schedule I.

16. Income Taxes***

The Company is included in the consolidated federal income tax return filed by its Parent. Federal income taxes are calculated as if the Company filed a separate federal income tax return. The Company files its own state and local tax returns. The current and deferred portions of the income tax expense (benefit) included in the statement of operations as determined in accordance with FASB Statement No. 109, *Accounting for Income Taxes*, are as follows:

	<u>Current</u>	<u>Deferred</u>	<u>Total</u>
Federal	\$5,204	\$(304)	\$4,900
State and local	1,280	680	1,960
Foreign	<u>240</u>	<u>—</u>	<u>240</u>
	<u>\$6,724</u>	<u>\$ 376</u>	<u>\$7,100</u>

A reconciliation of the difference between the expected income tax expense or income computed at the U.S. statutory income tax rate and the Company's income tax expense is shown in the following table.²¹

Expected income tax expense at U.S. statutory tax rate	\$4,659
The effect of:	
Nondeductible expenses	1,309
Increase due to state and local taxes, net of U.S. federal income tax effects	1,293
Tax-exempt income, net of related nondeductible interest expense	(427)
Other, net	<u>266</u>
Income tax expense ²²	<u>\$7,100</u>

17. Basic Earnings Per Share

Basic earnings per share of common stock were computed by dividing income available to common stockholders (net income, less the preferred stock dividend requirement), by the weighted average number of common shares outstanding for the year. Diluted earnings per share are not presented because the Company has issued no dilutive potential common shares.

*** In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This Interpretation also requires expanded disclosure with respect to the uncertainty in income taxes. FASB Interpretation No. 48 is effective for fiscal years beginning after December 15, 2006. See FASB Web site at www.fasb.org for full text of this Interpretation.

²¹ Optional disclosure for firms not subject to SEC Regulation S-X. An explanation of a disproportionate tax provision, however, is required under generally accepted accounting principles.

²² See paragraphs 43–45 of FASB Statement No. 109, *Accounting for Income Taxes*, for additional disclosures required, if material.

18. Consolidated Subsidiaries²³

The following is a summary of certain financial information of the Company's consolidated subsidiaries:

	<u>Broker- Dealer Jr.</u>	<u>Investment Advisory</u>	<u>Venture Capital</u>	<u>Total</u>
Total assets	\$12,700	\$1,700	\$5,100	\$19,500
Stockholders' equity	2,800	400	1,800	5,000

The \$2,800 of stockholder's equity and \$1,500 of the subordinated liabilities of the broker-dealer subsidiary are included as capital in a consolidated computation of the Company's net capital, because the assets of the subsidiary are readily available for the protection of the Company's customers, broker-dealers, and other creditors, as permitted by Rule 15c3-1. The accounts of the other subsidiaries are not included in the computation.

19. Collateral

Amounts that the Company has pledged as collateral, which are not reclassified and reported separately, at December 31, 20X6, consist of the following:

<u>Financial Statement Classification</u>	<u>Carrying Amount</u>
Securities owned	\$XXX
Spot commodities owned	\$XXX

The Company has accepted collateral with a fair value of \$XXX, at December 31, 20X6, that the Company is permitted by contract or custom, to sell or repledge, and has sold or repledged \$XXX of that collateral as of December 31, 20X6.^{24,25}

²³ Information in this note is presented to comply with FOCUS requirements (total assets and stockholders' equity of consolidated subsidiaries and treatment of the flow-through capital of the broker-dealer subsidiary). Readers should also consider FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*, which requires that public business enterprises report financial and descriptive information about its reportable operating segments.

²⁴ Paragraph 17 of FASB Statement No. 140 requires disclosure of information about the sources and uses of that collateral.

²⁵ Information in this note is presented to comply with FOCUS requirements (total assets and stockholders' equity of consolidated subsidiaries and treatment of the flow-through capital of the broker-dealer subsidiary). Readers should also consider FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*, which requires that public business enterprises report financial and descriptive information about its reportable operating segments.

Exhibit 4-9**Supplementary Information
Pursuant to Rule 17a-5 of the
Securities Exchange Act of 1934****As of December 31, 20X6**

The accompanying schedules are prepared in accordance with the requirements and general format of FOCUS Form X-17A-5. If desired, the preprinted FOCUS forms may be used for presenting the required supplementary information. The auditor should be aware of certain exemptive provisions under SEC Rule 15c3-3 regarding the computation of net capital (Schedule I) and the computation for the determination of reserve requirements (Schedule II). If the exemptive provisions apply, a note should be added by the broker-dealer to the schedules, stating the basis under which the broker-dealer claims exemption.

Schedule I

Standard Stockbrokerage Co., Inc.

Computation of Net Capital Under Rule 15c3-1 of the
Securities and Exchange Commission**(Dollars in Thousands)*

As of December 31, 20X6

Net Capital		
Total consolidated stockholders' equity		\$39,719
Deduct stockholders' equity not allowable for net capital [†]		<u>2,200</u>
Total stockholders' equity qualified for net capital		37,519
Add:		
Subordinated borrowings allowable in computation of net capital		9,897
Other (deductions) or allowable credits-deferred income taxes payable		<u>1,200</u>
Total capital and allowable subordinated borrowings		48,616
Deductions and/or charges:		
Nonallowable assets:		
Securities not readily marketable	\$1,730	
Exchange memberships	2,475	
Furniture, equipment, and leasehold improvements, net [‡]	2,381	
Other assets	<u>98</u>	
	6,684	
Additional charges for customers' and noncustomers' security accounts	825	
Additional charges for customers' and noncustomers' commodity accounts	78	
Aged fails-to-deliver	42	
Aged short security differences	44	
Secured demand note deficiency	525	
Commodity futures contracts and spot commodities/proprietary capital charges	163	
Other deductions and/or charges	<u>514</u>	<u>8,875</u>
Net capital before haircuts on securities positions (tentative net capital)		39,741
Haircuts on securities		
Contractual securities commitments	2,520	
Securities collateralizing secured demand notes	828	
Trading and investment securities		
Bankers' acceptances, certificates of deposit, and commercial paper		34

(continued)

U.S. and Canadian government obligations	543	
State and municipal government obligations	14	
Corporate obligations	237	
Stocks and warrants	1,682	
Options	212	
Undue concentrations	<u>87</u>	<u>6,157</u>
Net capital		<u>\$33,584</u>
Aggregate indebtedness		
Items included in consolidated statement of financial condition:#		
Short-term bank loans (secured by customer's securities)		\$18,400
Drafts payable		2,210
Payable to brokers and dealers		8,110
Payable to clearing broker		9,350
Payable to customers		11,716
Other accounts payable and accrued expenses		3,150
Items not included in consolidated statement of financial condition:		
Market value of securities borrowed for which no equivalent value is paid or credited		2,532
Other unrecorded amounts		<u>1,158</u>
Total aggregate indebtedness		<u>\$56,626</u>
Computation of basic net capital requirement		
Minimum net capital required:		
Company		\$ 3,775
Broker-dealer subsidiary		<u>428</u>
Total		<u>\$ 4,203</u>
Excess net capital at 1,500 percent		<u>\$29,381</u>
Excess net capital at 1,000 percent		<u>\$27,493</u>
Ratio: Aggregate indebtedness to net capital		<u>1.69 to 1</u>
Reconciliation with company's computation** (included in Part II of Form X-17A-5 as of December 31, 20X6)		
Net capital, as reported in Company's Part II (unaudited) FOCUS report		\$35,154
Allowable assets erroneously reported as nonallowable:		
Deposits		582
Accrued interest receivable		378

(continued)

Difference due to offsetting various asset accounts against related liabilities	(2,518)
Audit adjustments to record additional compensation	(600)
Other audit adjustments (net)	373
Other items (net)	<u>215</u>
Net capital per above	<u>\$33,584</u>
Computation of alternative net capital requirement ^{††}	
2 percent of aggregate debit items (or \$250,000, if greater) as shown in formula for reserve requirements pursuant to rule 15c3-3 prepared as of date of net capital computation—Company	\$1,077
Capital requirement of consolidated broker-dealer subsidiary electing alternative method	<u>162</u>
Total net capital requirement	<u>\$1,239</u>
Excess net capital ^{††}	<u>\$33,186</u>
Net capital in excess of—	
4 percent of aggregate debit items	<u>\$32,109</u>
5 percent of aggregate debit items	<u>\$31,570</u>

* Practitioners should consider the impact of recently issued accounting pronouncements when preparing or auditing this supplementary schedule.

† Excludes stockholder's equity of investment advisory and venture capital subsidiaries. See Note 18.

‡ Excludes \$2.5 million because of sole recourse of the related indebtedness.

|| Excludes \$222 of good-faith deposits for underwritings.

Excludes balances of consolidated subsidiaries other than wholly-owned broker-dealer subsidiaries included in consolidated computation of net capital.

** If there is no material difference from the company's computation and a reconciliation is not included, a statement to that effect is required.

†† To be included if the company has elected to use the alternative method of computing net capital pursuant to Appendix C of rule 15c3-1. In this case, aggregate indebtedness and the computation of basic net capital may be excluded.

†† Net capital under the alternative method is computed on a basis similar to the basic net capital computation; the broker-dealer would incur a 1 percent charge on fails-to-deliver (offset by fails-to-receive), and haircuts on securities would be reduced. In the examples above, net capital would have been \$34,425 under the alternative computation.

Schedule II

Standard Stockbrokerage Co., Inc.

Computation for Determination of Reserve Requirements
Under Rule 15c3-3 of the Securities and Exchange Commission*

(Standard Stockbrokerage Co., Inc. only)

(Dollars in Thousands)

As of December 31, 20X6

Credit balances

Free credit balances and other credit balances in customers' security accounts (including nonregulated commodity accounts, net of related margin deposits of \$322,300)	\$10,716
Monies borrowed collateralized by securities carried for the accounts of customers	18,400
Monies payable against customers' securities loaned	1,825
Customers' securities failed to receive (including credit balances in continuous net settlement accounts)	6,276
Credit balances in firm accounts that are attributable to principal sales to customers	1,238
Market value of stock dividends, stock splits, and similar distributions receivable outstanding over thirty calendar days	327
Market value of short security count differences over thirty calendar days old [†]	5
Market value of short securities and credits (not to be offset by "longs" or by debits) in all suspense accounts over thirty calendar days [†]	78
Market value of securities that are in transfer in excess of forty calendar days and have not been confirmed to be in transfer by the transfer agent or the issuer	<u>38</u>
Total credit items	<u>38,903</u>

(continued)

Debit balances	
Debit balances in customers' cash and margin accounts excluding unsecured accounts and accounts doubtful of collection net of deductions pursuant to Rule 15c3-3 [†]	38,988
Securities borrowed to effectuate short sales by customers and securities borrowed to make delivery on customers' securities failed to deliver	1,318
Failed to deliver of customers' securities not older than 30 calendar days (including debit balances in continuous net settlement accounts)	14,782
Other	<u>438</u>
Gross debits	<u>55,526</u>
Less 3 percent charge	<u>1,666</u>
Total debit items [†]	<u>53,860</u>
Reserve computation [†]	
Excess of total debits over total credits	<u>\$14,957</u>
Required deposit	<u>None</u>
Reconciliation with Company's computation [#] (included in Part II of Form X-17A-5 as of December 31, 20X6)	
Excess as reported in Company's Part II FOCUS report	\$15,496
Nonregulated commodity margin deposits erroneously excluded from the Company's computation	\$322
Other items, net	<u>217</u> (539)
Excess per above computation	<u>\$14,957</u>

* Practitioners should consider the impact of recently issued accounting pronouncements when preparing or auditing this supplementary schedule.

† Would be seven calendar days if the broker or dealer had elected the alternative net capital requirement under rule 15c3-1(f).

‡ Those firms calculating net capital under the basic method must reduce debit balances in customer accounts by 1 percent, whereas those calculating net capital under the alternative method are required to reduce total debits by 3 percent.

|| This caption may only include those interpretive items that do not belong in the captions specified by the rule.

If there are no material differences from the company's computation and a reconciliation is not included, a statement to that effect is required.

Schedule III**Standard Stockbrokerage Co., Inc.****Information Relating to Possession or Control Requirements Under
Rule 15c3-3 of the Securities and Exchange Commission*****(Standard Stockbrokerage Co., Inc. only)****(Dollars in Thousands)****As of December 31, 20X6**

1. Customers' fully paid and excess margin securities not in the respondent's possession or control as of the report date (for which instructions to reduce to possession or control had been issued as of the report date but for which the required action was not taken by respondent within the time frames specified under Rule 15c3-3): [†]	<u>\$18</u>
A. Number of items	<u>2</u>
2. Customers' fully paid securities and excess margin securities for which instructions to reduce to possession or control had not been issued as of the report date, excluding items arising from "temporary lags which result from normal business operations" as permitted under Rule 15c3-3. [‡]	<u>\$39</u>
A. Number of items	<u>5</u>

* Practitioners should consider the impact of recently issued accounting pronouncements when preparing or auditing this supplementary schedule.

[†] If the customers' fully paid securities are subsequently reduced to possession or control, a statement to that effect should be included.

[‡] In some instances, it may be impractical to determine the number of items in response to item 2. It may also be impractical to determine whether the company has subsequently issued instructions to reduce those items to possession or control or to determine that such instructions were acted on.

Schedule IV
Standard Stockbrokerage Co., Inc.
Schedule of Segregation Requirements and Funds
in Segregation for Customers' Regulated
Commodity Futures and Options Accounts*
(Dollars in Thousands)
As of December 31, 20X6

Segregation requirements	
Net ledger balance:	
Cash	\$ 976
Securities (at market)	784
Net unrealized profit (loss) in open futures contracts	(367)
Exchange traded options	
Add: market value of open option contracts purchased on a contract market	143
Deduct: market value of open option contracts granted (sold) on a contract market	<u>(129)</u>
Net equity (deficit)	1,407
Add: accounts liquidating to a deficit and accounts with debit balances with no open trades	<u>78</u>
Amount required to be segregated	1,485
Funds on deposit in segregation	
Deposited in segregated funds bank accounts:	
Cash	105
Securities representing investments of customers' funds (at market)	141
Securities held for customers in lieu of cash margins (at market)	784
Margins on deposit with clearing organizations of contracts markets:	
Cash	170
Securities representing investments of customers' funds (at market)	489
Settlement due from (to) contract market clearing organization	(28)
Exchange traded options:	
Add: unrealized receivables for option contracts purchased on contract markets	143
Deduct: unrealized obligations for option contracts granted (sold) on contract markets	(129)
Net equities with other FCMS	<u>37</u>
Total amount in segregation	<u>1,712</u>
Excess funds (insufficiency) in segregation	<u>\$ 227</u>

* Practitioners should consider the impact of recently issued accounting pronouncements when preparing or auditing this supplementary schedule.

Chapter 5

Auditing Considerations*

General Considerations

5.01 The primary purpose of a financial statement audit of a broker-dealer is to express an opinion on management's financial statements. As discussed in the "Regulatory Environment" section of this chapter, the auditor is also required to report on the adequacy of the broker-dealer's internal control in accordance with SEC Rule 17a-5(g)(1) and on its compliance with specific rules addressing financial responsibility and recordkeeping. Auditors of issuer broker-dealers are also required to audit and report on management's assessment of the company's internal control over financial reporting in conjunction with their audit of the company's financial statements. AU section 320 of PCAOB Standards, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*), establishes requirements and provides directions that apply when an auditor is engaged to audit both a company's financial statements and management's assessment of the effectiveness of internal control over financial reporting. Chapter 6 of this Audit and Accounting Guide (Guide) discusses the auditor's consideration of internal control in the audit of a broker-dealer's financial statements and provides an overview of the types of control and monitoring activities that are unique to brokers-dealers. This Guide is not intended to provide guidance to auditors on how to comply with the requirements of AU section 320 of PCAOB Standards although it highlights, as appropriate, additional requirements imposed by that standard. The objective of the auditing section of this Guide is to assist the independent auditor in auditing the financial statements of broker-dealers in accordance with both AICPA professional standards (referred to as "generally accepted auditing standards" or "GAAS") and PCAOB professional standards and in complying with regulatory requirements discussed below. The term "audit" generally refers to the audit of financial statements unless it is indicated that the discussion pertains to the integrated audit or audit of internal controls.

5.02 The auditor, prior to accepting a new audit client or continuing a relationship with an existing client, should ascertain that the audit engagement can be conducted in accordance with GAAS or PCAOB standards. If he or she is satisfied that an audit can be conducted, the auditor should plan the audit to determine the nature, timing, and extent of the audit tests to be performed. The

* Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the Preface). The Preface also discusses the Sarbanes-Oxley Act requirement that *all* broker-dealers (both public and private) be audited by a public accounting firm registered with the PCAOB and the SEC deferral of that requirement.

In March 2006, the ASB issued eight SASs (SAS No. 104 through SAS No. 111) related to risk assessment. It is anticipated that to implement the SASs appropriately, many firms will have to make significant revisions to their audit methodologies and train their personnel accordingly. The SASs are effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. Refer to the Preface of this Guide for more information. It is anticipated that the May 2007 edition of this Guide will be updated to reflect changes arising from these eight SASs.

As applicable, this chapter contains dual referencing to both the AICPA and the PCAOB professional standards. Refer to the Preface for more information on dual referencing.

auditor and the broker-dealer should establish a clear understanding, preferably in writing, of the scope of audit services to be performed and the auditor's responsibilities regarding any accompanying information. The nature, timing, and extent of audit procedures to be performed and the type of reports to be issued are based on the scope of the services required. In addition, the volatility and level of activity of some accounts in the broker-dealer affect the auditor's decision about performing interim substantive tests, such as confirming balances.

Regulatory Environment

5.03 The regulatory environment has a major effect on the audit of a broker-dealer because of the requirements that the auditor report on the adequacy of the broker-dealer's internal control in accordance with SEC Rule 17a-5(g)(1) and on its compliance with 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 as part of the audit of financial statements.

5.04 The objectives of the annual audit of the financial statements of a broker-dealer are discussed in Securities and Exchange Commission (SEC) Rule 17a-5. The rule requires that the audit be made in accordance with GAAS and include a review of the accounting system, the internal accounting control and procedures for safeguarding securities, including appropriate tests for the period since the prior audit date. Rule 17a-5 requires the audit to include all procedures necessary to enable the auditor to express an opinion on the following:

- The statements of financial condition, results of operations, and cash flows
- The computation of net capital under SEC Rule 15c3-1
- The computation for determination of reserve requirements for broker-dealers under SEC Rule 15c3-3
- Information relating to the possession or control requirements under SEC Rule 15c3-3

5.05 SEC Rule 17a-5 recommends that auditors consider synchronizing the application of auditing procedures and performing tests in certain areas simultaneously.

5.06 Accordingly, although auditors may exercise their professional judgment in making those decisions, they may be expected to justify a choice not to synchronize certain substantive tests (such as confirming customer transactions and open or unsettled transactions with other broker-dealers and transfer agents, and substantiating stock record positions by counting securities or through other appropriate means).

5.07 In planning and performing the audit of financial statements, the auditor should obtain reasonable assurance that any material inadequacies existing at the audit report date in the following areas would be disclosed:

- The accounting system
- Internal control
- Procedures for safeguarding securities
- The practices and procedures whose review is specified by SEC Rule 17a-5

5.08 In addition, as specific objectives, the audit of financial statements should include reviews of the practices and procedures followed by the broker-dealer in—

- Making the periodic computations, pursuant to SEC Rule 17a-3(a)(11), of aggregate indebtedness or aggregate debit items under the alternative method and net capital under SEC Rule 15c3-1 and the reserve required by SEC Rule 15c3-3.
- Making the quarterly securities examinations, counts, verifications and comparisons, and recording of differences required by SEC Rule 17a-13.
- Complying with the requirements for prompt payment for securities under Federal Reserve Regulation T (Regulation T) of the Board of Governors of the Federal Reserve System.
- Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers, as required by SEC Rule 15c3-3.

5.09 This review should include a determination as to the adequacy of procedures described in the records required to be maintained pursuant to SEC Rule 15c3-3(d)(4).

5.10 For a broker-dealer that is exempt from Rule 15c3-3, the auditor should ascertain that the conditions of the exemption were being complied with as of the audit report date and that no facts came to the auditor's attention indicating that the exemption had not been complied with during the period since the last audit.

5.11 A material inadequacy in the accounting system, internal accounting controls, procedures for safeguarding securities, and practices and procedures referred to in paragraph (g)(1) of SEC Rule 17a-5 that is expected to be reported under these audit objectives includes any condition that has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to cause any of the following:

- a. Inhibit a broker-dealer from promptly completing securities transactions or promptly discharging its responsibilities to customers, other broker-dealers, or creditors
- b. Result in material financial loss
- c. Result in material misstatements in the broker-dealer's financial statements
- d. Result in violations of the SEC's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in SEC Rule 17a-5(g)(3)

Planning the Audit Engagement

5.12 Before the start of the audit, the auditor should review the guidance in AU section 311, *Planning and Supervision*[†] (AICPA, *Professional Standards*,

[†] For audits of privately held entities or other "non issuers," SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311) has been superseded by SAS No. 108 by the same name. SAS No. 108 is effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. Refer to the Preface of this Guide for more information.

vol. 1; AICPA, *PCAOB Standards and Related Rules*), regarding specific procedures that should be considered in planning an audit of financial statements in accordance with GAAS or PCAOB standards. Planning involves the development of an overall strategy for the expected conduct of the audit. The nature, timing, and extent of planning will vary according to the type of broker-dealer, its size, and the complexity of its operations.

Considerations for Integrated Audits

When performing an integrated audit of financial statements and internal control over financial reporting in accordance with PCAOB standards (subsequently referred to as "integrated audit"), the auditor should refer to paragraph 39 of AU section 320 of PCAOB Standards regarding planning considerations in addition to the planning considerations discussed in AU section 311. (*Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2*, AU sec. 311.01)

5.13 The planning process comprises the following four elements:

- a. *Understanding the business.* To gain an understanding of the business, important factors that affect the broker-dealer should be considered. Procedures normally include discussions with key personnel, visits to principal locations, and reviews of internal and published material. Consideration should be given to external factors such as those that are political, economic, and industry-related (including the use of outside service bureaus) and important internal factors such as the structure of the organization, management's strategies, the company's arrangement for clearing and safeguarding customer securities, and factors affecting the broker-dealer's operations, finances, sales, trading, and personnel. The nature and extent of the required information should be determined in light of the particular circumstances of each audit.
- b. *Carrying out preliminary analytical procedures.* Analytical procedures should be applied to the financial data to be reported on. This will enable the auditor to identify unusual or unexpected relationships or balances and understand the broker-dealer's significant accounting, operational, and regulatory policies.
- c. *Obtaining an overview of the financial, operational, and regulatory compliance system.* The auditor should acquire an overview of the financial, operational, and regulatory compliance systems to gain insight into the overall environment and a preliminary understanding of the flow of transactions and important controls.
- d. *Assessing the control environment.* The auditor should assess the overall attitude, awareness, and actions of the owners, the governing board, and management concerning the importance of control and the emphasis it is given in the broker-dealer's operations. The nature, size, and complexity of the broker-dealer's operations should be consistent with its control environment. However, a weak control environment may provide management with the opportunity to neglect regulatory compliance.

5.14 The planning process enables the auditor to identify factors that indicate an increase in the risk of misstatement and provides a context within which to develop appropriate audit responses.

Establishing an Understanding With the Client

5.15 AU section 310, *Appointment of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), requires the auditor to establish an understanding with the client that includes the objectives of the engagement, the responsibilities of management and the auditor, and any limitations of the engagement. The Statement requires the auditor to document the understanding with the client in the audit documentation, preferably through a written communication with the client. The Statement provides guidance to the auditor for situations in which the practitioner believes that an understanding with the client has not been established.

Considerations for Integrated Audits

When performing an integrated audit, the auditor should refer to paragraph .06 of AU section 310 (AICPA, *PCAOB Standards and Related Rules*) which includes requirements specific to the integrated audit related to (1) the objective of the audit, (2) the responsibility of the auditor for conducting the audit in accordance with PCAOB standards, and (3) the responsibility of the auditor for communicating certain matters in writing to various parties, including management.

5.16 AU section 310 also identifies specific matters that ordinarily would be addressed in the understanding with the client, and other contractual matters an auditor might wish to include in the understanding. Paragraph 46 of AT section 101, "Attest Engagements" (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), provides guidance on establishing an understanding with the client regarding the services to be performed for attest engagements.

Audit Risks

5.17 AU section 312, *Audit Risk and Materiality in Conducting an Audit*[†] (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), provides guidance on consideration of audit risk and materiality when planning and performing an audit of financial statements. AU section 312^a describes audit risk as the risk that the auditor may fail to modify his or her opinion on financial statements that are materially misstated, and describes the following components of audit risk:

- Inherent risk relates to the sensitivity of an account or class of transaction to material misstatement, assuming that there are no related controls. Inherent risk is greater for some types of accounts than for others (for example, the inherent risk for cash and securities in the vault is greater than the inherent risk for plant assets). However, other factors (such as an impending business failure) may typically increase the inherent risk for all account balances and classes of transactions. Financial statement balances derived from accounting estimates pose

[†] For audits of privately held entities or other "non issuers," SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312) has been superseded by SAS No. 107 by the same name. SAS No. 107 is effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. Refer to the Preface of this Guide for more information.

^a AU section 312 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

greater risk than do those derived from relatively routine, factual data.

- Control risk relates to the effectiveness of the broker-dealer's internal control. It represents the risk that the broker-dealer's internal control will not detect on a timely basis or prevent a material misstatement in an account or a class of transaction.
- Detection risk is a function of the accountant's ability to audit the broker-dealer's transactions and accounts satisfactorily. It relates to the risk that the auditor will fail to detect material misstatements in the financial statements. Detection risk can be controlled and reduced to an acceptably low level by supervision and proper planning and other quality control activities.

5.18 In planning an audit of a broker-dealer, the auditor should assess the effect of the regulatory environment, changes in that environment, and the expectations of the client, its customers, and regulators on both audit risk and materiality. In determining the scope of audit procedures to be performed, the auditor should be aware of certain aspects of the broker-dealer's operations that are usually subject to a greater level of audit risk than others. The auditor should consider, among other factors, the effectiveness of the broker-dealer's internal control, materiality, inherent risk, and the possible need to synchronize the timing of certain auditing procedures. In the chart entitled "Securities Broker-Dealer Auditing Considerations" at the end of this chapter, see the "Regulatory" section under the column heading, "Group of Accounts."

5.19 The auditor's judgment about the level of audit risk may affect engagement staffing, the extent of supervision, and the scope of the audit. For instance, for an aspect of the audit that is judged to involve high risk, the auditor should consider staffing the engagement with auditors having relevant experience in auditing the aspect assessed to have high risk and should increase the nature, timing, and extent of the audit work.

Materiality

5.20 FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, states that information is material if, in the light of the surrounding circumstances, the judgment of a reasonable person relying on the information would have been changed or influenced by its omission or misstatement. That suggests that the auditor, when making materiality judgments, should consider both the circumstances of the broker-dealer as well as the information needs of those who rely on the financial statements. Auditing Interpretation No. 4 "Considering the Qualitative Characteristics of Misstatements," in AU section 9312 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*) provides guidance on the qualitative factors that the auditor should consider in assessing whether misstatements are material. AU section 312.40 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), among other matters, requires the auditor to document the nature and effect of misstatements that the auditor aggregates as well as the auditor's conclusion as to whether the aggregated misstatements cause the financial statements to be materially misstated.

Considerations for Integrated Audits

When performing an integrated audit, refer to paragraphs 22–23 of AU section 320 of PCAOB Standards regarding materiality considerations.

(Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, AU sec. 312.03)

5.21 Materiality is established by the auditor in the planning stage of the audit, in the evaluation of the audit evidence, and in the final determination of the audit report to be rendered.¹ The auditor may make an initial judgment regarding materiality levels in planning the audit and may utilize another level in evaluating the audit findings. The discrepancy in levels may be due to information that was obtained during the course of the audit, as well as overall changing circumstances. Some other common factors used by auditors in ascertaining the materiality level for a broker-dealer include the following:

- The absolute or relative size of the misstatement
- The nature of the misstatement
- The cumulative effects of any and all known or likely misstatements
- Any uncertainty surrounding the misstatement

Illegal Acts

5.22 AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*),¹¹ provides guidance on the nature and extent of the considerations the auditor should give to the possibility of illegal acts by clients. The term *illegal acts*, for the purposes of AU section 317,^b relates to violations of laws or government regulations. Illegal acts may vary considerably in their relation to the financial statements. The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. AU section 317^b provides that the auditor's responsibility to detect and report misstatements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts is the same as that for material fraud as described in AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*). That is, the auditor should design the audit to obtain reasonable assurance of detecting illegal acts that have a direct and material effect on the financial statements.

5.23 Broker-dealers may be affected by many laws or regulations, including those related to fair practice, securities trading, underwriting, and

¹ SEC Staff Accounting Bulletin (SAB) No. 99, *Materiality*, addresses the application of materiality thresholds in the preparation and audit of financial statements filed with the SEC. Among other matters, SAB No. 99 addresses the evaluation of misstatements discovered in the financial reporting and auditing processes. SAB No. 99 does not create new standards or definitions for materiality, but reaffirms the concepts of materiality as expressed in the accounting and auditing literature.

¹¹ In November 2004, the AICPA's Professional Issues Task Force issued Practice Alert 2004-1, *Illegal Acts*, to provide auditors of nonissuers and their firms with guidance regarding the extent of the consideration an independent auditor should give to the possibility of illegal acts by a client in an audit of financial statements in accordance with generally accepted auditing standards. The Alert provides guidance regarding the auditor's responsibility for detecting illegal acts that have a direct or indirect effect on the financial statements; audit procedures in the absence of specific information indicating the existence of possible illegal acts; what should be done if you discover possible illegal acts; disclosure of illegal acts to third parties; reporting considerations and documentation. The Professional Issues Task Force encourages practitioners and AICPA member firms to incorporate the guidance contained in the Alert as soon as practicable. The Alert is currently available on the AICPA's Web site at www.aicpa.org/download/auditstd/pract_alert/PA_2004_1.pdf.

^b AU section 317 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

customer transactions. The laws and regulations generally relate more to a broker-dealer's operating aspects than to its financial and accounting aspects, and their financial statement effects are indirect. Normally, an audit of financial statements in accordance with GAAS or PCAOB standards does not include audit procedures specifically designed to detect illegal acts that have an indirect effect on the financial statements. However, the auditor may become aware of the possibility of such acts during the course of performing procedures for the purpose of forming an opinion on the financial statements. AU section 317^b provides guidance with respect to the auditor's response to such possible illegal acts.

Audit Sampling

5.24 AU section 350, *Audit Sampling*[#] (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), provides guidance for planning, performing, and evaluating both statistical and nonstatistical audit samples. The Statement also includes discussions intended to enhance professional judgment in assessing sampling risk, planning samples, sample selection, and performance and evaluation. The AICPA Audit Guide *Audit Sampling* presents recommendations to help auditors apply audit sampling in accordance with AU section 350.^c The components of audit risk may be quantified into numerical terms such as percentages or into nonnumerical terms such as low or high. The Appendix to AU section 350^c contains two models that may be used to quantify those variables and others for statistical sampling purposes. It can easily be shown that there is an inverse relationship between inherent risk, control risk, and detection risk (that is, between the first two risks and the third). Thus, the lower the inherent and control risk, the greater the detection risk the auditor can accept.

5.25 When considering AU section 350^c to determine the suitable level of tests for audit procedures, the initial focus is on analysis of audit risk. In assessing audit risk as it relates specifically to broker-dealers, the following two unique characteristics become obvious: (a) a high volume of transactions and (b) a highly controlled environment.

5.26 As with any audit, sampling can be utilized in a broker-dealer audit for tests of controls or verifying account balances. Some areas in which sampling may be used in a broker-dealer audit include the following:

- *Verification of customer balances.* The auditor will generally not need to confirm all account balances; thus sampling would be appropriate.
- *Verification of the stock record.* Sampling may be used in the following three ways:
 - (a) To select securities maintained on the client's premises for physical inspection and counting
 - (b) To confirm securities held by various depositories

^b See footnote b in paragraph 5.22.

[#] For audits of privately held entities or other "non issuers," SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350) has been amended by SAS No. 111, *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling. SAS No. 111 is effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. Refer to the Preface of this Guide for more information.

^c AU section 350 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

- (c) To test clearing organization reconciliations, confirming street-side accounts (such as fails, stock loan, and stock borrow), or reviewing suspense accounts
- *Letter on internal control.* Sampling may be used in the following two ways:
 - (a) To determine the adequacy of the broker-dealers' practices and procedures relating to performing the net capital and reserve requirement computations, security counts, and compliance with Regulation T
 - (b) To obtain and maintain physical possession or control of required securities during the year in order to issue the auditor's letter on internal control
- *Net capital computation.* Sampling may be used to test the accuracy and completeness of the broker-dealer's schedule of aged fails-to-receive and fails-to-deliver and short security count differences, to test the market values of firm inventory and the related regulatory haircuts in the broker-dealer's net capital computation as of the balance sheet date.
- *Reserve requirement computation.* Sampling may be used to test the accuracy and completeness of the broker-dealer's allocation of securities between the customer and the firm, and to review adjustments made to certain balance sheet accounts that were previously tested by the auditor.
- *Possession or control requirements.* Sampling may be used to test the accuracy and completeness of information regarding violations, if any, of possession or control requirements as of the balance sheet date.

Audit Objectives

5.27 AU section 326, *Evidential Matter*** (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), provides the auditor with guidance on the third standard of fieldwork. Most of the auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter regarding management's assertions in financial statements. Assertions are representations by management that are embodied in financial statements. They can be either explicit or implicit. Those assertions can be classified into the following five broad categories.

- a. *Existence or occurrence.* Do assets or liabilities of the broker-dealer exist at a given date, and have recorded transactions occurred during the given period?
- b. *Completeness.* Are all transactions and account balances that should be presented in the financial statements included?
- c. *Rights and obligations.* Do all assets belong to the entity, and are all liabilities obligations of the broker-dealer at a given date?

** For audits of privately held entities or other "non issuers," SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326) has been superseded SAS No. 106, *Audit Evidence*. SAS No. 106 is effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. Refer to the Preface of this Guide for more information.

- d. *Valuation or allocation.* Have all asset, liability, revenue, and expense components been included in the financial statements at their appropriate amounts?
- e. *Presentation and disclosure.* Are components of the financial statements properly classified, described, and disclosed?

5.28 In selecting particular substantive tests to achieve the audit objectives that the auditor has developed, the auditor should consider (a) the assessment of the level of control risk, (b) the relative risk of material misstatements that might occur in the financial statements, and (c) the expected effectiveness and efficiency of tests. Such considerations include the materiality of the items being tested, the kind and competence of available evidential matter, and the nature of the audit objective to be achieved. The results of the auditor's tests and assessment of the level of inherent risk and control risk should provide a reasonable basis for the auditor's opinion.

5.29 In identifying audit risks, the auditor needs to consider how material misstatements might occur. There are six types of possible misstatements: four that can arise in the processing and recording of transactions that make up the account balance, and two that can arise in the preparation of financial statements. The four potential misstatements concerning the account balance relate to the following audit assertions.

- a. *Completeness.* Transactions are not recorded.
- b. *Validity.* Recorded transactions are not valid.
- c. *Recording.* Transactions are recorded inaccurately. They may be recorded in the wrong amount or may be misclassified, or misstatements may arise in summarizing or transferring transactions from one record to another.
- d. *Cutoff.* Transactions are recorded in accounts in the wrong period.

5.30 The misstatements related to the foregoing assertions may result in the related account balances being incomplete (assets or obligations are not recorded), invalid (recorded assets do not exist or do not belong to the entity, or recorded obligations do not exist), or inaccurate (assets or obligations are recorded in the wrong amount).

5.31 The two potential misstatements that can arise in the preparation of financial statements relate to the following assertions:

- a. *Valuation.* Assets or liabilities are incorrectly valued, (meaning that they do not properly reflect existing business circumstances and economic conditions).
- b. *Presentation.* Account balances are presented in a misleading way, or not all the information that is necessary for a fair presentation and compliance with professional standards or legal requirements is disclosed.

5.32 In obtaining evidential matter in support of financial statement assertions, the auditor develops specific audit objectives in the light of those assertions. In developing the audit objectives of a particular engagement, the auditor should consider the specific circumstances of the broker-dealer, including the type of business activity the broker-dealer engages in and its unique accounting practices.

5.33 There is not necessarily a one-to-one relationship between audit objectives and audit procedures. Some procedures may relate to more than one objective. A combination of procedures may be needed to achieve a single objective. The chart entitled, "Securities Broker-Dealers' Auditing Considerations," at the end of this chapter, provides illustrations of audit assertions, audit objectives, and substantive tests. The chart is intended neither to be all-inclusive nor to suggest that specific audit objectives or substantive procedures should be applied.

5.34 The chart is arranged by broad audit objectives. Such classifications may be useful in the evaluation process, but the classifications are of secondary importance. Some specific objectives may achieve more than one broad objective. A number of the objectives may not be relevant to a particular broker-dealer because of the nature of its operations or the absence of certain types of transactions.

Audit Documentation

Audits Conducted in Accordance With GAAS

Guidance Based on SAS No. 96

5.35 AU section 339.01, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1) provides that the auditor should prepare and maintain audit documentation, the form and content of which should be designed to meet the circumstances of the particular audit engagement. Audit documentation is the principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in the engagement. The quantity, type, and content of audit documentation are matters of the auditor's professional judgment. AU section 339 (AICPA, *Professional Standards*, vol. 1), provides requirements about the content, ownership and confidentiality of audit documentation. Moreover, Appendix A to AU section 339 (AICPA, *Professional Standards*, vol. 1) lists the audit documentation requirements contained in other areas of the AICPA, *Professional Standards*.

Guidance Based on SAS No. 103

5.36 In December 2005 the Auditing Standards Board issued SAS No. 103, *Audit Documentation*. SAS No. 103 supersedes SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339) and amends SAS No. 1, section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 530). The amendment to SAS No. 1 changes the date of the auditor's report from the date of completion of fieldwork to require that the auditor's report be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. SAS No. 103 is effective for audits of financial statements for periods ending on or after December 15, 2006 with earlier application permitted.

5.37 For auditors electing earlier application of SAS No. 103, paragraphs 5.38–5.42 along with other guidance found in SAS No. 103 will apply.

5.38 The auditor **must** prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit

procedures performed), the audit evidence obtained and its source, and the conclusion reached. Audit documentation:

- a. Provide the principal support for the representation in the auditor's report that the auditor performed the audit in accordance with generally acceptable auditing standards.
- b. Provides that principal support for the opinion expressed regarding the financial information or the assertion to the effect that an opinion cannot be expressed.

5.39 Audit documentation is an essential element of audit quality. Although documentation alone does not guarantee audit quality, the process of preparing sufficient and appropriate documentation contributes to the quality of an audit.

5.40 Audit documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. Audit documentation, also known as working papers or workpapers, may be recorded on paper or on electronic or other media. When transferring or copying paper documentation to another media, the auditor should apply procedures to generate a copy that is faithful in form and content to the original paper document.

5.41 Audit documentation includes, for example audit programs, analyses, issues memoranda, summaries of significant findings or issues, letters of confirmation and representation, checklists, abstracts or copies of important documents, correspondence (including e-mail) concerning significant findings or issues, and schedules of the work the auditor performed. Abstracts or copies of the entity's records (for example, significant and specific contracts and agreements) should be included as part of the audit documentation if they are needed to enable an experienced auditor to understand the work performed and conclusions reached. The audit documentation for a specific engagement is assembled in an audit file.

5.42 SAS No. 103 includes additional requirements related to the following topics that should be complied with:

- Form, content, and extent of audit documentation,
- Significant findings and issues,
- Identification of preparer and reviewer,
- Documentation of specific items tested,
- Documentation of departures from statements on auditing standards, and
- Revisions to audit documentation.

Audits Conducted in Accordance With PCAOB Standards

5.43 AU section 339 of PCAOB Standards, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules*) establishes general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to PCAOB standards. Audit documentation is the written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise. Audit documentation facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work because it provides the reviewer

with written documentation of the evidence supporting the auditor's significant conclusions. Among other things, audit documentation includes records of the planning and performance of the work, the procedures performed, evidence obtained, and conclusions reached by the auditor.

5.44 The auditor must prepare audit documentation in connection with each engagement conducted pursuant to the standards of the PCAOB. Audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached. Also, the documentation should be appropriately organized to provide a clear link to the significant findings or issues. Examples of audit documentation include memoranda, confirmations, correspondence, schedules, audit programs, and letters of representation. Audit documentation may be in the form of paper, electronic files, or other media.

5.45 AU section 339 of PCAOB Standards provides additional guidance on documentation of specific matters, and retention of and subsequent changes to audit documentation. See AU section 339 of PCAOB Standards for further guidance.

5.46 AU section 320.159 of PCAOB Standards, *Audit of Internal Control Over Financial Reporting* (AICPA, *PCAOB Standards and Related Rules*) requires that in addition to the documentation requirements of AU section 339 of PCAOB Standards, the auditor should document certain items related to their audit of internal control over financial reporting.

Consideration of Fraud in a Financial Statement Audit

5.47 AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in paragraph .02 of AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*).

Considerations for Integrated Audits

When performing an integrated audit, the auditor should refer to paragraphs 24–26 of AU section 320 of PCAOB Standards regarding fraud considerations, in addition to the fraud considerations set forth in AU section 316. (*Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2*, AU sec. 316.01)

5.48 There are two types of misstatements relevant to the auditor's consideration of fraud in a financial statement audit:

- Misstatements arising from fraudulent financial reporting.
- Misstatements arising from misappropriation of assets.

5.49 Three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure*, which

provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an *opportunity* for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act.

The Importance of Exercising Professional Skepticism

5.50 Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud

5.51 Members of the audit team should discuss the potential for material misstatement due to fraud in accordance with the requirements of paragraphs 14 through 18 of AU section 316.^d The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the known external and internal factors affecting the entity that might (a) create incentives/pressures for management and others to commit fraud, (b) provide the opportunity for fraud to be perpetrated, and (c) indicate a culture or environment that enables management to rationalize committing fraud. Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit.

5.52 Additional discussion and examples of fraud risk factors for brokers and dealers in securities, classified based on the three conditions generally present when material misstatements due to fraud occur (1) incentives/pressures, (2) opportunities, and (3) attitudes/rationalizations, are included in Appendix A [paragraph 5.181] to this chapter.

Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

5.53 AU section 311.06–.08[†] (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), provides guidance about how the auditor obtains knowledge about the entity's business and the industry in which it operates. In performing that work, information may come to the auditor's attention that should be considered in identifying risks of material misstatement due to fraud. As part of this work, the auditor should perform

^d Paragraphs .14 through .18 of AU section 316 can be found in AICPA *Professional Standards* and *PCAOB Standards and Related Rules*

[†] See footnote † in paragraph 5.12.

the following procedures to obtain information that is used (as described in paragraphs 35 through 42 of AU section 316^e) to identify the risks of material misstatement due to fraud:

- a. Make inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed. (See paragraphs 20 through 27 of AU section 316.^f)
- b. Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit. (See paragraphs 28 through 30 of AU section 316.^g)
- c. Consider whether one or more fraud risk factors exist. (See paragraphs 31 through 33 of AU section 316,^h the Appendix to AU section 316ⁱ and paragraph 5.55 of this Guide.)
- d. Consider other information that may be helpful in the identification of risks of material misstatement due to fraud. (See paragraph 34 of AU section 316.^j)

5.54 In planning the audit, the auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting. See Appendix A [paragraph 5.181] to this chapter for examples of unusual or unexpected relationships that may indicate a material misstatement due to fraud for brokers and dealers in securities.

5.55 *Considering Fraud Risk Factors.* As indicated in paragraph 5.53c, the auditor may identify events or conditions that indicate incentives/pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Such events or conditions are referred to as "fraud risk factors." Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

5.56 AU section 316 provides fraud risk factor examples that have been written to apply to most enterprises. As discussed in paragraph 5.52 of this Guide, Appendix A [paragraph 5.181] to this chapter contains a list of fraud risk factors specific to brokers and dealers in securities. Remember that fraud risk factors are only one of several sources of information an auditor considers when identifying and assessing risk of material misstatement due to fraud.

^e Paragraphs .35 through .42 of AU section 316 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

^f Paragraphs .20 through .27 of AU section 316 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

^g Paragraphs .28 through .30 of AU section 316 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

^h Paragraphs .31 through .33 of AU section 316 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

ⁱ The Appendix of AU section 316 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

^j Paragraph .34 of AU section 316 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

Identifying Risks That May Result in a Material Misstatement Due to Fraud

5.57 In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in accordance with the requirements of paragraphs 19 through 34 of AU section 316.^k The auditor's identification of fraud risks may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. In addition, the auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial-statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management. Appendix A [paragraph 5.181] to this chapter provides examples, specific for brokers and dealers in securities, on accounts, classes of transactions and assertions that may have high inherent risk because they involve a high degree of management judgment and subjectivity and are susceptible to manipulation by management.

A Presumption That Improper Revenue Recognition Is a Fraud Risk

5.58 Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition (see paragraph 41 of AU section 316^l). Additional examples of improper revenue recognition for brokers and dealers in securities is included in Appendix A [paragraph 5.181] to this chapter.

A Consideration of the Risk of Management Override of Controls

5.59 Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk (see paragraph 57 of AU section 316^m) apart from any conclusions regarding the existence of more specifically identifiable risks. Specifically, the procedures described in paragraphs 58 through 67 of AU section 316ⁿ should be performed to further address the risk of management override of controls. These procedures include (1) examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, (2) reviewing accounting estimates for biases that could result in material misstatement due to fraud, and (3) evaluating the business rationale for significant unusual transactions.

^k Paragraphs .19 through .34 of AU section 316 can be found in *AICPA Professional Standards* and *PCAOB Standards and Related Rules*.

^l Paragraph .41 of AU section 316 can be found in *AICPA Professional Standards* and *PCAOB Standards and Related Rules*.

^m Paragraph .57 of AU section 316 can be found in *AICPA Professional Standards* and *PCAOB Standards and Related Rules*.

ⁿ Paragraphs .58 through .67 of AU section 316 can be found in *AICPA Professional Standards* and *PCAOB Standards and Related Rules*.

Key Estimates

5.60 Examples of key estimates for brokers and dealers in securities are provided in Appendix A [paragraph 5.181] to this chapter.

Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks

5.61 Auditors should comply with the requirements of paragraphs 43 through 45 of AU section 316^o concerning an entity's programs and controls that address identified risks of material misstatement due to fraud. Examples of programs and controls for brokers and dealers in securities are provided in Appendix A [paragraph 5.181] to this chapter.

5.62 The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud or whether specific control deficiencies exacerbate the risks. After the auditor has evaluated whether the entity's programs and controls have been suitably designed and placed in operation, the auditor should assess these risks taking into account that evaluation. This assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud.

Responding to the Results of the Assessment

5.63 Paragraphs 46 through 67 of AU section 316^p provide requirements and guidance about an auditor's response to the results of the assessment of the risks of material misstatement due to fraud. The auditor responds to risks of material misstatement due to fraud in the following three ways:

- a. A response that has an overall effect on how the audit is conducted—that is, a response involving more general considerations apart from the specific procedures otherwise planned (see paragraph 50 of AU section 316^q).
- b. A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed (see paragraphs 51 through 56 of AU section 316^r). Examples of auditing procedures that could be performed by auditors of brokers and dealers in securities are provided in Appendix A [paragraph 5.181] to this chapter.
- c. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur (see paragraphs 57 through 67 of AU section 316^s and paragraph 5.59 of this Guide).

^o Paragraphs .43 through .45 of AU section 316 can be found in *AICPA Professional Standards and PCAOB Standards and Related Rules*.

^p Paragraphs .46 through .67 of AU section 316 can be found in *AICPA Professional Standards and PCAOB Standards and Related Rules*.

^q Paragraph .50 of AU section 316 can be found in *AICPA Professional Standards and PCAOB Standards and Related Rules*.

^r Paragraphs .51 through .56 of AU section 316 can be found in *AICPA Professional Standards and PCAOB Standards and Related Rules*.

^s Paragraphs .57 through .67 of AU section 316 can be found in *AICPA Professional Standards and PCAOB Standards and Related Rules*.

Evaluating Audit Evidence

5.64 Paragraphs 68 through 78 of AU section 316^t provide requirements and guidance for evaluating audit evidence. The auditor should evaluate whether analytical procedures that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. The auditor also should consider whether responses to inquiries throughout the audit about analytical relationships have been vague or implausible, or have produced evidence that is inconsistent with other evidential matter accumulated during the audit.

5.65 At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

Responding to Misstatements That May Be the Result of Fraud

5.66 When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. See paragraphs 75 through 78 of AU section 316^u for requirements and guidance about an auditor's response to misstatements that may be the result of fraud. If the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements, the auditor nevertheless should evaluate the implications, especially those dealing with the organizational position of the person(s) involved.

5.67 If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should:

- a. Attempt to obtain additional evidential matter to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report thereon.²
- b. Consider the implications for other aspects of the audit (see paragraph 76 of AU section 316^v).
- c. Discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level

^t Paragraphs .68 through .78 of AU section 316 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

^u Paragraphs .75 through .78 of AU section 316 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

² See AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), for guidance on auditor's reports issued in connection with audits of financial statements.

^v Paragraph .76 of AU section 316 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

above those involved, and with senior management and the audit committee.³

d. If appropriate, suggest that the client consult with legal counsel.

5.68 The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

Communicating About Possible Fraud to Management, the Audit Committee, and Others

5.69 Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. See paragraphs 79 through 82 of AU section 316^{w,4} for further requirements and guidance about communications with management, the audit committee, and others.

Documenting the Auditor's Consideration of Fraud

5.70 Paragraph 83 of AU section 316^x requires certain items and events to be documented by the auditor. Auditors should comply with those requirements.

Practical Guidance

5.71 The AICPA Practice Aid, *Fraud Detection in a GAAS Audit*—(Revised Edition), provides a wealth of information and help on complying with the provisions of AU section 316.^y Moreover, this Practice Aid provides an understanding

³ If the auditor believes senior management may be involved, discussion of the matter directly with the audit committee may be appropriate.

^w Paragraphs .79 through .82 of AU section 316 can be found in AICPA *Professional Standards and PCAOB Standards and Related Rules*.

⁴ PCAOB guidance provided in paragraph 80 of AU section 316 (AICPA, *PCAOB Standards and Related Rules*) differs from the AICPA guidance in paragraph 80 of AU section 316 (AICPA, *Professional Standards*, vol. 1) as follows: the phrase "the auditor should consider whether these risks represent reportable conditions relating to the entity's internal control that should be communicated to senior management and the audit committee" used in the AICPA *Professional Standards* was replaced with "the auditor should consider whether these risks represent significant deficiencies that must be communicated to senior management and the audit committee" in the PCAOB Standards. Also, the reference to section 325, "Communication of Internal Control Related Matters Noted in an Audit," paragraph .04 in the AICPA *Professional Standards* was replaced with the reference to section 325, "Communications About Control Deficiencies in An Audit of Financial Statements," paragraph 4 in the PCAOB Standards.

In May 2006, the ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, which supersedes SAS No. 60 (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 112 is effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier implementation is permitted. Among other matters, SAS No. 112 eliminates the term "reportable conditions" from the AICPA *Professional Standards* and incorporates the definitions of the terms *control deficiency*, *significant deficiency*, and *material weakness* used in Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. Please refer to paragraphs 5.101-5.103 of this chapter for a discussion of SAS No. 112.

^x Paragraph .83 of AU section 316 can be found in AICPA *Professional Standards and PCAOB Standards and Related Rules*.

^y AU section 316 can be found in AICPA *Professional Standards and PCAOB Standards and Related Rules*.

of the differences between the requirements of AU section 316.^y This Practice Aid is an Other Auditing Publication as defined in AU section 150, *Generally Accepted Auditing Standards*^{††} (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply auditing standards.

Internal Control

5.72 AU section 319, *Consideration of Internal Control in a Financial Statement Audit*^{††} (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), defines internal control and states that the auditor's primary concern in the audit of financial statements is to obtain an understanding of internal control sufficient to plan the audit. Auditors of issuers are also required to attest to and report on management's assessment of the company's internal control over financial reporting in conjunction with their audit of the company's financial statements in accordance with AU section 320 of PCAOB Standards. As discussed in paragraph 5.01, this Guide is not intended to provide guidance to auditors on how to comply with the requirements of AU section 320 of PCAOB Standards although it highlights, as appropriate, additional requirements imposed by that standard.

5.73 The internal control of a broker-dealer is described in Chapter 6, "Internal Control," of this Guide. The auditor should obtain an understanding of each of the five components of internal control described in AU section 319.^z That understanding should be sufficient to plan the audit of financial statements. A sufficient understanding is obtained by performing procedures to understand the design of controls relevant to the audit of financial statements, and determining whether they have been placed in operation, by—

- Making inquiries of the broker-dealer's personnel.
- Observing activities and operations.
- Inspecting documents and records.
- Relying on past experience with the particular broker-dealer.

5.74 After obtaining an understanding of the components of the broker-dealer's internal control, the auditor should assess the control risk for the assertions⁵ that are embodied in the classes of transactions, account balances,

^y See footnote y in paragraph 5.71.

^{††} For audits of privately held entities or other "non issuers," SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150) has been amended by SAS No. 105, *Amendment to Statement on Auditing Standards No. 95*, *Generally Accepted Auditing Standards*. SAS No. 105 is effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. Refer to the Preface of this Guide for more information.

^{††} For audits of privately held entities or other "non issuers," SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319) has been superseded by SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. SAS No. 109 and No. 110 are effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. Refer to the Preface of this Guide for more information.

^z AU section 319 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

⁵ PCAOB guidance provided in AU section 319.02 (AICPA, *PCOAB Standards and Related Rules*) differs from the AICPA guidance in AU section 319.02 (AICPA, *Professional Standards*, vol. 1) as follows: the term "assertions" used in the AICPA *Professional Standards* was replaced with the term "relevant assertions" in the PCAOB Standards.

and disclosure components of the financial statements. The auditor's evaluation of the assessed level of control risk and the auditor's understanding of the broker-dealer's internal control are instrumental in determining the nature, timing, and extent of substantive tests that will be performed on the financial statement assertions.

5.75 For audits conducted in accordance with PCAOB standards, regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements. The auditor should refer to paragraphs 68–70 of AU section 320 of PCAOB Standard for a discussion of identifying relevant financial statement assertions. (*Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2*, AU sec. 319.02)

Documentation

5.76 The auditor should document the understanding of the broker-dealer's internal control components obtained to plan the audit of financial statements and his or her conclusions about the assessed level of control risk. Conclusions about the assessed level of control risk may differ as they relate to various account balances or classes of transactions. For those financial statement assertions in which control risk is assessed at the maximum level, the auditor should document his or her conclusion that control risk is at the maximum level.

5.77 For those assertions in which the assessed level of control risk is below the maximum level, the auditor should document the basis for his or her conclusion that the effectiveness of the design and operation of controls supports that assessed level. The nature and extent of the auditor's documentation are influenced by the assessed level of control risk, the nature of the entity's internal control, and the nature of the entity's documentation of its internal control.

Considerations for Integrated Audits

When performing an integrated audit, if the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion. Accordingly, if control risk is assessed at the maximum level, the auditor should document the basis for that conclusion. Refer to paragraphs 159–161 of AU sec. 320 of PCAOB Standards for additional information regarding documentation requirements. (*Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2*, AU sec. 319.65 and .83)

Consideration of the Work of Internal Auditors

5.78 In audits of broker-dealers, independent auditors may consider using the work of internal auditors. If the independent auditor will be considering or using the work of or receiving direct assistance from the broker-dealer's internal auditors, the provisions of AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1; *PCAOB Standards and Related Rules*), provide guidance relating to the independent auditor's consideration of internal auditors' competence and objectivity and in evaluating their work.

5.79 AU section 322^{aa} also provides guidance concerning the independent auditor's use of work performed by the internal audit function. Reviewing and testing internal control is often an important responsibility of the internal audit function. Thus, the work of the internal auditors may have an important bearing on the independent auditor's procedures. If the independent auditor intends to consider or use the work of or receive direct assistance from the broker-dealer's internal auditors, the independent auditor should follow the guidance in AU section 322^{aa} in considering the competence and objectivity of the internal auditor and in evaluating their work.

Considerations for Integrated Audits

When performing an integrated audit, the auditor should refer to paragraphs 108–126 of AU section 320 of PCAOB Standards for a discussion on using the work of others to alter the nature, timing, and extent of the work that otherwise would have been performed to test controls. (*Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2*, AU sec. 322.01)

5.80 The broker-dealer's internal auditors or other personnel can also be used to prepare schedules, obtain documentation, and research matters. As objectivity and competence increase, the level of utilization of broker-dealers' personnel may increase as well. For certain internal audit procedures that are objective, competent, and well supervised, independent audit procedures may consist of reviewing and testing internal audit work rather than the broker-dealer's systems and accounts.

Analytical Procedures

5.81 Analytical procedures are one of the most effective planning tools used by the auditor to identify potential areas of high risk. AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), requires that analytical procedures be performed during the planning stage and overall review stages of all audits. The Statement notes that analytical procedures should be performed in planning the audit, not only to improve the auditor's understanding of the broker-dealer's business and the transactions and events that have occurred since the last audit date, but also to highlight unusual relationships and unexpected fluctuations in the financial information that may require further investigation during the audit. The AICPA Audit Guide *Analytical Procedures* provides practical guidance to auditors on the effective use of analytical procedures. This Audit Guide includes a discussion of AU section 329;^{bb} concepts and definitions; a series of questions and answers; an illustrative case study; and an appendix that includes useful financial ratios.

5.82 Analytical procedures involve the systematic analysis and comparison of recorded amounts or ratios derived from recorded amounts with expectations that have been developed by the auditor. Those expectations may be developed by identifying plausible relations that are reasonably expected

^{aa} AU section 322 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

^{bb} AU section 329 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

to exist based on understanding the broker-dealer and the industry in which it operates. The goal is to determine any unusual fluctuations, trends, ratios, transactions, events, and amounts that indicate that special attention is merited. Specifically, auditors of broker-dealers may use the following information in performing analytical procedures:

- Internally prepared budgets
- Prior-period financial information
- Forecasts
- Extrapolations from interim data
- Comparisons with industry statistics, broker-dealer financial information, or statistical data prepared by the Securities Industry Association or other industry groups
- Comparisons of financial information with relevant nonfinancial information

5.83 Analytical procedures can be used when assessing inherent risk, including accounts or audit areas that require particular attention or those items that need little or no audit emphasis. Analytical procedures are especially useful because of the ease in obtaining information with which to assess a broker-dealer, which thus permits easy identification of areas where greater or lesser effort are necessary. Analytical procedures may be useful as part of the initial planning process to—

- Enhance knowledge of the broker-dealer's business.
- Provide a basis for preliminary judgments about materiality.
- Increase awareness of inherent risk factors.
- Direct attention to accounts and classes of transactions (or changes in them) that merit additional audit emphasis.

5.84 Analytical procedures may be useful during the engagement to—

- Corroborate the results of substantive tests of details applied to an account or group of related accounts.
- Be used instead of substantive tests of details applied to accounts or portions of accounts where a low level of audit assurance would be desired.
- Be used instead of substantive tests of details applied to accounts over which controls operate and have been found to be effective, or to accounts related to other accounts that have been tested through other substantive procedures.
- Highlight the need for or assist in the design of specific substantive tests.
- Assess the risk of further misstatements in accounts.

5.85 At the conclusion of an engagement, analytical procedures may be useful to (a) confirm the results of other audit procedures and (b) help ensure that the auditor is aware of the reasons for all significant fluctuations.

5.86 The auditor may apply analytical procedures to financial statement captions, account balances, and quarterly financial statements, although the extent and timing of the procedures will vary from one broker-dealer to another.

5.87 Specific analytical procedures that may be applicable to a broker-dealer include the following:

- Interest income as a percentage of the average balances of resale transactions, customers' margin receivables, and stock borrows (separately computed), to compare with the average earnings yield on resale transactions, customer margin receivables, and stock borrows, respectively
- Interest expense as a percentage of the average balances of repurchase (repo) transactions, customer payables, and stock loans (separately computed), to compare with the yields incurred on repo transactions, customer payables, and stock loans
- Mutual fund fees by type compared with transaction volume (such as front-end-load fee income compared with the volume of mutual funds sold to customers or redemption fee income compared with the volume of mutual funds redeemed by customers)
- Management fees compared with the amount of funds under management
- Exchange fees, listed commission income, and expenses as compared with the trading volume on exchanges
- Sales credits on over-the-counter (OTC) trades compared with OTC trading volume
- For nonclearing broker-dealers, the level of interest income or interest expense compared with their money balance at the clearing broker-dealer

5.88 AU section 329.22 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), requires that the auditor document certain matters when an analytical procedure is used as the principal substantive test of a significant financial statement assertion.

5.89 For audits conducted in accordance with PCAOB standards, AU section 329 (AICPA, *PCAOB Standards and Related Rules*) provides that before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information. (*Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2*, AU sec. 329.16) Furthermore, PCAOB standards indicate that for significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient. (*Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2*, AU sec. 329.09)

Auditing Accounting Estimates

5.90 As part of the scope of audit procedures to be performed, the auditor should be aware that certain areas of an audit of broker-dealers' operations require estimates that may be material in the preparation and presentation of the broker-dealer's financial statements. An accounting estimate is an approximation of a financial statement element, item, or account instead of a precise measurement.

5.91 Professional judgment is required in formulating an estimate. Although it is the responsibility of a broker-dealer's management to prepare estimates for the financial statements, the auditor is responsible for evaluating their reasonableness. AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), provides guidance for the auditor on obtaining and evaluating sufficient, competent evidential matter in support of accounting estimates included in the financial statements.

5.92 Although significant accounting estimates may affect many elements of a broker-dealer's financial statements, they often affect the following:

- Valuation of securities that are not readily marketable or other investments
- Estimates of compensation for deferred 12b-1 fees
- Reserves for promissory notes to account executives (contract notes usually forgiven over three to five years)
- Customer reserves
- Estimates of the useful lives of plant, property, and equipment
- Underwriting costs accrued and capitalized based on a high percentage of recovery
- Employee compensation plans
- Valuation of exchange memberships
- The estimate of deferred taxes
- Unrealized gain or loss on swap transactions
- Unrealized gain or loss on forwards, futures, and other unsettled transactions and commitments

5.93 Although management is responsible for making estimates, the auditor is responsible for evaluating the reasonableness of estimates and should consider appropriate procedures in planning and performing the audit. Those procedures should include both subjective and objective factors. In evaluating accounting estimates for reasonableness, the auditor should understand how management developed those estimates. Based on that understanding, the auditor should decide on one or a combination of the following three approaches to assess reasonableness.

- a. Review and test the process used by management to develop the estimate. To satisfy this approach, the following procedures may be performed.
 - (1) Determine what controls (if any) are in operation over the preparation of accounting estimates and the supporting data that may be useful in that evaluation.
 - (2) Determine whether factors that management used in forming the underlying assumptions are relevant, reliable, and sufficient based on information gathered from other audit tests.
 - (3) Consider whether the assumptions are consistent with one another, the supporting data, relevant historical data, and industry data.

- (4) Consider whether changes in the broker-dealer's business or industry may affect the assumptions underlying the accounting estimates.
 - (5) Test the calculations used by management to convert the assumptions and other factors into the accounting estimates.
- b. Develop independent expectations of the estimates used by management for corroboration. Based on the understanding of the facts and circumstances relating to the broker-dealer, the auditor should generate independent expectations that are based on alternative assumptions, as a means of confirming the reasonableness of the accounting estimates.
 - c. Review subsequent events or transactions occurring before completion of fieldwork. To evaluate the reasonableness of accounting estimates, the auditor may find it helpful to consider events or transactions occurring after the date of the balance sheet but before the completion of fieldwork.

Considerations for Integrated Audits

When performing an integrated audit, the auditor may use any of the three approaches. However, the work that the auditor performs as part of the audit of internal control over financial reporting should necessarily inform the auditor's decisions about the approach he or she takes to auditing an estimate because, as part of the audit of internal control over financial reporting, the auditor would be required to obtain an understanding of the process management used to develop the estimate and to test controls over all relevant assertions related to the estimate. (*Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2*, AU sec. 342.10)

5.94 As investment strategies increasingly include investing in more complex and higher risk securities, the values of securities may not be readily available through market quotations. Such securities are often valued at amounts determined by the broker-dealers' management. Auditing the valuation of such securities is an area that requires a high degree of judgment and scrutiny to ensure that the valuation procedures are reasonable and underlying support is appropriate. There is no single method for determining fair value in good faith because fair value depends on the facts and circumstances of each individual case. In auditing securities valuations determined by management, auditors should review the information that formed the basis for the valuations and ascertain that the procedures followed were reasonable. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), provides guidance on auditing fair value measurements and disclosures contained in financial statements. Under AU section 328,^{cc} the auditor's substantive tests of fair value measurements involve (a) testing management's significant assumptions, the valuation model, and the underlying data, (b) developing independent fair value estimates for corroborative purposes, or (c) examining subsequent events and

^{cc} AU section 328 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

transactions that confirm or disconfirm the estimate. In some instances, the auditor may consider using the work of a specialist in auditing the valuation of such securities. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), provides guidance when auditors consider the work done by a specialist. AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), among other matters, provides guidance to auditors in planning and performing auditing procedures for assertions about investments in securities that are made in an entity's financial statements. A companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides practical guidance for implementing AU section 332.

Audits Conducted in Accordance With GAAS

5.95 Auditing Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist," in AU section 9332 (AICPA, *Professional Standards*, vol. 1), which interprets AU section 332, provides guidance for audits conducted in accordance with GAAS pertaining to situations where a readily determinable fair value does not exist. For example, an entity may have an investment in a hedge fund that it reports at fair value, but for which a readily determinable fair value does not exist. Further, the hedge fund may own interests in investments in limited partnership interests or other private equity securities for which a readily determinable fair value does not exist. As part of an auditor's procedures in accordance with AU section 332, the auditor typically would satisfy the existence assertion through either confirmation with the hedge fund, examination of legal documents, or other means as discussed in AU section 332. In confirming the existence, the auditor may request the hedge fund to indicate or to confirm the fair value of the entity's investment in the hedge fund, including the fair value of investments held by the hedge fund. In some circumstances, the hedge fund will not provide management or the auditor detailed information about the basis and method for measuring the entity's investment in the hedge fund, nor will they provide information about the specific investments held by the hedge fund. For example, in some circumstances the hedge fund may inform management or the auditor that investments are held by the hedge fund as follows:

- In aggregate, such as "\$XXX of total investments"
- In aggregate, such as "\$XXX of total investments in private equity securities, \$YYY of total investments in interests in limited partnerships, and \$ZZZ of total investments in debt securities"
- On an investment-by-investment basis, such as "AA shares of common stock of private company A, with a fair value of \$AAA; BB shares of preferred stock of private company B, with a fair value of \$BBB; CC units of limited partnership interest CCC, with a fair value of \$CCC; and real estate property DDD, with a fair value of \$DDDD"

In circumstances in which the auditor determines that the nature and extent of auditing procedures should include verifying the existence and testing the measurement of investments in securities, simply receiving a confirmation from a third party, either in aggregate or on a security-by-security basis, does not in and of itself constitute adequate audit evidence with respect to the valuation assertion in AU section 332. In addition, receiving confirmation from a third party for investments in aggregate (illustrated by the first two bullets above)

does not constitute adequate audit evidence with respect to the existence assertion under AU section 332. Receiving confirmation from a third party on a security-by-security basis (illustrated by the third bullet above), however, typically would constitute adequate audit evidence with respect to the existence assertion under AU section 332.

5.96 Auditing Interpretation No. 1, "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value," in AU section 9328 (AICPA, *Professional Standards*, vol. 1), which interprets AU section 328, provides guidance in connection with confirmations received for interest in trusts held by a third-party trustee. The guidance in this interpretation is similar to guidance in AU section 9332 (discussed in the preceding paragraph) and is applicable to audits conducted in accordance with GAAS. The full text of these interpretations can be viewed at www.aicpa.org/download/auditstd/announce/Audit_Interpretations_Auditing_Fair_Value.pdf

Going-Concern Considerations

5.97 AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), provides guidance to the auditor with respect to evaluating whether there is substantial doubt about the broker-dealer's ability to continue as a going concern.

5.98 Continuation of a broker-dealer as a going concern is assumed in financial reporting in the absence of significant information to the contrary. Ordinarily, information that significantly contradicts the going-concern assumption relates to the broker-dealer's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, noncompliance with various rules and regulations, externally forced revision of its operations, or similar actions. The ability of a broker-dealer to meet statutory net capital requirements is a major factor to consider in assessing the going-concern assumption.

5.99 During the course of the audit, the auditor may become aware of information that raises substantial doubt about the broker-dealer's ability to continue as a going concern. AU section 341^{dd} states that the auditor has a responsibility to evaluate whether there is substantial doubt about the broker-dealer's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. The evidence necessary to make this evaluation will usually be obtained through planning and gathering evidential matter relative to the various audit objectives (including review of compliance with debt agreements, analytical procedures, and subsequent events) and through completing the audit. If, after considering the identified conditions and events in the aggregate, the auditor believes that there is substantial doubt about the ability of a broker-dealer to continue as a going concern, he or she should consider management's plans to mitigate the current conditions and events, the effect on the financial statements and the related disclosures, and the effects on the auditor's report. AU section 341.17 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB*

^{dd} AU section 341 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

Standards and Related Rules), requires the auditor to document certain matters if, after considering the identified conditions and events in the aggregate, the auditor believes there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.

Communication of Matters Related to Internal Control

Audits Conducted in Accordance With GAAS

Guidance Based on SAS No. 60

5.100 AU section 325, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1), provides guidance in identifying and reporting conditions that relate to a broker-dealer's internal control observed during an audit of financial statements. AU section 325 requires that reportable conditions be communicated to the entity's audit committee or individuals with a level of authority and responsibility equivalent to an audit committee (such as the board of directors, an owner in an owner-managed broker-dealer, or others who may have engaged the auditor) for broker-dealers that do not have one. Reportable conditions are matters coming to the auditor's attention that, in his or her judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of internal control that could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Conditions noted by the auditor that are considered reportable under AU section 325 should be reported. If reportable conditions are communicated orally, the auditor should document the communication by appropriate memoranda or notations in the audit documentation. AU section 532.09, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1) states that a report issued under AU section 325 should be restricted because the purpose of the engagement is to report on the entity's financial statements, not to provide assurance on its internal control.

Guidance Based on SAS No. 112

5.101 In May 2006, the ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, which supersedes SAS No. 60 (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 112 is effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier implementation is permitted. Among other matters, SAS No. 112 makes the following changes to the existing guidance:

- Incorporates the definitions of the terms *control deficiency*, *significant deficiency*, and *material weakness* used in Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*.
- Requires the auditor to communicate significant deficiencies and material weaknesses to management and those charged with governance.
- Requires that the communication be in writing.

5.102 For auditors who audit financial statements for periods ending on or after December 15, 2006, or choose to implement SAS No. 112 early, paragraph 5.103, which has been modified to conform to SAS No. 112, along with other guidance found in SAS No. 112, will apply.

5.103 AU section 325, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1), provides guidance on evaluating and communicating matters related to a broker-dealer's internal control over financial reporting identified during an audit of financial statements. AU section 325 requires that control deficiencies identified during the audit that upon evaluation are considered significant deficiencies or material weaknesses be communicated in writing to management and those charged with governance as a part of each audit, including significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits, and have not yet been remediated. A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. AU section 325 provides that the communication should state that it is intended solely for the information and use of management, those charged with governance, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties. If an entity is required to furnish such auditor communications to a governmental authority, specific reference to such governmental authorities may be made.

Audits Conducted in Accordance With PCAOB Standards

5.104 AU section 325 of PCAOB standards, *Communications About Control Deficiencies in an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*) provides guidance on identifying and reporting deficiencies in the company's internal control over financial reporting in an audit of financial statements in accordance with PCAOB standards. It provides that the auditor must communicate in writing to management and the audit committee all significant deficiencies and material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on the financial statements. The auditor's communication should distinguish clearly between those matters considered significant deficiencies and those considered material weaknesses.

5.105 If oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, that circumstance should be regarded as at least a significant deficiency and as a strong indicator that a material weakness in internal control over financial reporting exists which the auditor must communicate in writing to the board of directors.

5.106 The auditor might identify matters in addition to those required to be communicated by AU section 325 of PCAOB standards. Such matters include control deficiencies identified by the auditor that are neither significant deficiencies nor material weaknesses and matters the company may request the auditor to be alert to that go beyond those contemplated by this standard. The auditor may report such matters to management, the audit committee, or others, as appropriate.

5.107 The auditor should not report in writing that no significant deficiencies were discovered during an audit of financial statements because of the potential that the limited degree of assurance associated with such a report will be misunderstood.

Considerations for Integrated Audits

When performing an integrated audit, the auditor should refer to paragraphs 207–214 of AU section 320 of PCAOB standards, *Audit of Internal Control Over Financial Reporting* (AICPA, *PCAOB Standards and Related Rules*) for guidance on required communications.

Communication With Audit Committees or Equivalent Bodies^{||||}

5.108 AU section 380, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), establishes a requirement for the auditor to determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for oversight of the financial reporting process. The communications required by AU section 380,^{ee} are applicable to broker-dealers that either have an audit committee or have otherwise formally designated overseeing financial reporting to a group equivalent to an audit committee, such as a finance committee or budget committee. AU section 380^{ee} requires the auditor to inform the audit committee about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented, whose effects management believes are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. AU section 380^{ee} also requires an auditor of SEC clients to discuss with audit committees the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial statements. AU section 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*) refers to reports issued

^{||||} In March 2006, the ASB issued an exposure draft of a proposed SAS, *The Auditor's Communication With Those Charged With Governance*, which will replace SAS No. 61, *Communication With Audit Committees*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 380). This proposed SAS establishes standards and provides guidance to auditors of privately held entities or other "non issuers" on matters to be communicated with those charged with governance.

SAS No. 61 currently establishes communication requirements applicable to entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee. The proposed SAS broadens the applicability of the SAS to audits of the financial statements of all nonissuers and establishes a requirement for the auditor to communicate with those charged with governance certain significant matters related to the audit.

The exposure draft is available at: www.aicpa.org/members/div/auditstd/Proposed_Statement_of_Auditing_Standards.htm

^{ee} AU section 380 can be found in AICPA *Professional Standards* and *PCAOB Standards and Related Rules*.

under AU section 380^{ee} as by-product reports, and states that the use of such reports should be restricted.

Management Representations

5.109 AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), establishes a requirement that an auditor, performing an audit in accordance with GAAS or PCAOB standards, obtain written representations from management for all financial statements and periods covered by the auditor's report. AU section 333^{ff} also provides guidance concerning the representations to be obtained, along with an illustrative management representation letter. The management representation letter should include an acknowledgement by management that the effects of any uncorrected financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of the uncorrected misstatements should be included in or attached to the representation letter. Certain other representations related to a broker-dealer's operations are normally obtained (see Appendix G, "Representation Letter," of this Guide).

Considerations for Integrated Audits

When performing an integrated audit, the auditor should refer to paragraphs 142–144 of AU section 320 of PCAOB Standards for additional required written representations to be obtained from management. (*Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2*, AU sec. 333.05)

5.110 In August 2002, the SEC adopted final rules for "Certification of Disclosure in Companies' Quarterly and Annual Reports." In response to Section 302(a) of the Sarbanes-Oxley Act of 2002, Chief Executive Officers (CEOs) and Chief Financial Officers (CFOs), or persons performing similar functions, are now required to certify the financial and other information contained in quarterly and annual reports and make certain disclosures. This certification includes (among other things) (a) the accuracy of the filed report, (b) the design of the issuer's internal accounting controls, and (c) the disclosure to the audit committee of any material weaknesses in those controls.

5.111 As part of the certification of financial statements required by the Sarbanes-Oxley Act of 2002, the CEO and the CFO of a publicly held broker-dealer are required to disclose to the broker-dealer's audit committee and independent auditors all significant deficiencies in the design or operation of internal controls which could adversely affect the broker-dealer's ability to record, process, summarize and report financial data, and to identify to the auditors any material weaknesses in internal controls. Further, they are to disclose to the audit committee and the auditors any fraud, whether or not material, that involves management or other employees who have a significant role in the broker-dealer's internal controls.

5.112 AU section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1; AICPA,

^{ee} See footnote ee in this paragraph.

^{ff} AU section 333 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

PCAOB Standards and Related Rules), requires the auditor to obtain evidential matter relevant to litigation, claims, and assessments. AU section 337⁸⁸ concludes that a letter of inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments. The auditor should obtain a client representation about the following factors:

- The existence of a condition, situation, or set of circumstances indicating an uncertainty about the possible loss to a broker-dealer 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

Nature, Timing, and Extent of Auditing Procedures

5.113 With respect to the extent and timing of auditing procedures, SEC Rule 17a-5 also states, in part:

The extent and timing of audit procedures are matters for the independent public accountant to determine on the basis of his (or her) review and evaluation of existing internal controls and other audit procedures performed in accordance with generally accepted auditing standards and the audit objectives set forth in paragraph (g) above. In determining the extent of testing, consideration shall be given to the materiality of an area and the possible effect on the financial statements and schedules of a material misstatement in a related account. The performance of auditing procedures involves the proper synchronization of their application and thus comprehends the need to consider simultaneous performance of procedures in certain areas such as, for example, securities counts, transfer verification and customer and broker confirmation in connection with verification of securities positions.

5.114 Certain auditing procedures (including security counts and related confirmations) may be performed at a date other than the date of the financial statements. AU section 313, *Substantive Tests Prior to the Balance Sheet Date* (AICPA, *Professional Standards*, vol. 1; *PCAOB Standards and Related Rules*), provides guidance on factors to be considered before applying substantive tests to details of asset and liability accounts at a date prior to the date of the financial statements. In determining the extent of procedures to be performed, the auditor should consider the materiality of an area and the possible effect of a material misstatement in the financial statements and related schedules. Guidance concerning the timing of tests of controls in connection with the audit of financial statements is provided in AU section 319.99^{††} of the *AICPA Professional Standards*, vol. 1.

Considerations for Integrated Audits

When performing an integrated audit, the auditor should refer to paragraphs 88–107 of AU section 320 of *PCAOB Standards* which provide

⁸⁸ AU section 337 can be found in *AICPA Professional Standards* and *PCAOB Standards and Related Rules*.

^{††} See footnote †† in paragraph 5.72.

directions about the nature, timing, and extent of testing of the design and operating effectiveness of internal control over financial reporting. (Paragraph B30 of AU section 320 (AICPA, *PCAOB Standard and Related Rules*)

5.115 In addition, the audit scope for review and testing of procedures relative to net capital, quarterly security counts, and compliance with Regulation T and Rule 15c3-3 should be sufficient to provide reasonable, but not absolute, assurance that any material inadequacies existing at the audit date would be disclosed as prescribed in Rule 17a-5.

5.116 The auditor should plan the audit of financial statements to obtain reasonable assurance that potential misstatements, either individually or in aggregate, have not caused the financial statements to be materially misstated. In developing the audit plan, the auditor should consider (a) whether management has established controls that might be relied on and (b) the nature and extent of the substantive testing needed, based on the assessment of risk and the decision whether to rely on internal control.

Considerations for Integrated Audits

When performing an integrated audit, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on management's assessment of the company's internal control over financial reporting when concluding on the effectiveness of controls for the purpose of assessing *control risk*. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies. (AU sec. 320.151 [AICPA, *PCAOB Standards and Related Rules*])

If, during the audit of internal control over financial reporting, the auditor identifies a control deficiency, he or she should determine the effect on the nature, timing, and extent of substantive procedures to be performed to reduce the risk of material misstatement of the financial statements to an appropriately low level. (AU sec. 320.156 [AICPA, *PCAOB Standards and Related Rules*])

In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of all substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. (AU sec. 320.157 [AICPA, *PCAOB Standards and Related Rules*])

Effect of Information Technology on Internal Control

5.117 The auditor should consider the methods the broker-dealer uses to process accounting information because the methods that are used, together with the complexity of the processing system, may influence the nature, timing, and extent of the audit procedures to be performed. The use of computers is often an important element of a broker-dealer's processing and control environment, regardless of the size of the business. The large volume of transactions and the need to maintain accountability for security positions (both ownership and location) have caused most broker-dealers to automate their recordkeeping systems.

5.118 AU section 319^{††} states that in obtaining an understanding of internal control sufficient to plan the audit of financial statements, the auditor considers how an entity's use of information technology (IT) and manual procedures may affect controls relevant to the audit. IT encompasses automated means of originating, processing, storing, and communicating information, and includes recording devices, communication systems, computer systems, and other electronic devices. The auditor is primarily interested in the entity's use of IT to initiate, record, process, and report transactions or other financial data. An entity's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives, and its operating units or business functions. The use of IT also affects the fundamental manner in which transactions are initiated, recorded, processed, and reported.

5.119 IT provides potential benefits of effectiveness and efficiency for an entity's internal control, and also poses specific risks to an entity's internal control. The extent and nature of the specific risks to internal control vary depending on the nature and characteristics of the entity's information system.

5.120 The auditor, when assessing control risk in terms of financial statement assertions, should consider, among other things, the nature and complexity of the systems, including the use of IT, by which the entity processes and controls information supporting the assertion. In circumstances where a significant amount of information supporting one or more financial statement assertions is electronically initiated, recorded, processed, or reported, the auditor may determine that it is not possible to design effective substantive tests that by themselves would provide sufficient evidence that the assertions are not materially misstated. For such assertions, significant audit evidence may be available only in electronic form. In such cases, its competence and sufficiency as evidential matter usually depend on the effectiveness of controls over its accuracy and completeness. Furthermore, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, recorded, processed, or reported only in electronic form and appropriate controls are not operating effectively. In such circumstances, the auditor should perform tests of controls to gather evidential matter to use in assessing control risk.

5.121 The auditor should consider whether specialized skills are needed for the auditor to determine the effect of IT on the audit, to understand the IT controls, or to design and perform tests of IT controls or substantive tests. A professional possessing IT skills may be either on the auditor's staff or an outside professional. The auditor should also consider whether specialized skills are needed to design or perform tests of automated controls.

5.122 Guidance for auditing records in which IT is significant may be found in the AICPA Audit Guide *Consideration of Internal Control in a Financial Statement Audit*.

Consideration of Controls at IT Service Centers

5.123 A broker-dealer may use outside service organizations (sometimes referred to as service centers) to perform services that are part of the

^{††} See footnote †† in paragraph 5.72.

broker-dealer's information system. A service organization's services are part of an entity's information system if they affect any of the following—

- The classes of transactions in the entity's operations that are significant to the entity's financial statements
- The procedures, both automated and manual, by which the entity's transactions are initiated, recorded, processed, and reported from their occurrence to their inclusion in the financial statements
- The related accounting records, whether electronic or manual, supporting information, and specific accounts in the entity's financial statements involved in initiating, recording, processing and reporting the entity's transactions
- How the entity's information system captures other events and conditions that are significant to the financial statements
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures

The use of a service organization may improve internal control because of the separation of responsibilities inherent in the third-party status of the service organization. Accordingly, transactions that affect its financial statements flow through accounting systems that are—at least in part—physically and operationally separate from the broker-dealer.

5.124 AU section 319^{††} states that the auditor should obtain an understanding of an entity's internal control, sufficient to plan the audit. This understanding may encompass controls placed in operation by the broker-dealer and by service organizations whose services are part of the broker-dealer's information system.

5.125 AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), explains the considerations an auditor should make in obtaining an understanding of internal control and assessing control risk for entities that use a service organization to process transactions. See paragraphs 5.117 through 5.122 for a discussion of the auditor's consideration of an entity's use of IT.

5.126 The auditor should identify significant classes of transactions that are processed by the service center and understand the flow of transactions through the entire accounting system, including the portion maintained by the service center. The facts and circumstances of each case should determine the additional work that needs to be done by the auditor with regard to controls at the service center. If, for example, after examining the output of the service center, the auditor is satisfied that the broker-dealer can check the daily output throughout the year, he or she may not need to consider the service center's processing controls any further. However, the auditor should inquire about problems pertaining to system continuity or data file security that are due to inadequate equipment or program backup or to poor control at the service center.

^{††} See footnote †† in paragraph 5.72.

5.127 Information about the nature of the services provided by the service organization that are part of the broker-dealer's information system and the service organization's controls over those services may be available from sources such as user manuals, system overviews, technical manuals, the contract between the broker-dealer and the service organization, and reports by auditors of the service organization (service auditors), internal auditors, or regulatory authorities on the service organization's controls. If the services and the service organization's controls over those services are highly standardized, information obtained through the broker-dealer auditor's prior experience with the service organization may be helpful in planning the audit.

5.128 After considering the available information, the auditor of the broker-dealer may conclude that he or she has the means to obtain a sufficient understanding of internal control to plan the audit of financial statements. If the auditor of the broker-dealer concludes that information is not available to obtain a sufficient understanding to plan the audit of financial statements, he or she may consider contacting the service organization, through the broker-dealer, to obtain specific information or request that a service auditor be engaged to perform procedures that will supply the necessary information, or the auditor of the broker-dealer may visit the service organization and perform such procedures. If the auditor of the broker-dealer is unable to obtain sufficient evidence to achieve his or her audit objectives, the auditor of the broker-dealer should qualify his or her opinion or disclaim an opinion on the financial statements because of a scope limitation.

5.129 In considering whether the service auditor's report is satisfactory for his or her purposes, the broker-dealer's auditor should make inquiries concerning the service auditor's professional reputation. See AU section 324^{hh} for further guidance.

5.130 If the auditor believes that the service auditor's report may not be sufficient to meet his or her objectives, the auditor may supplement his or her understanding of the service auditor's procedures and conclusions by discussing with the service auditor the scope and results of the service auditor's work. In addition, if the auditor believes it is necessary, he or she may contact the service organization, through the broker-dealer, to request that the service auditor perform agreed-upon procedures at the service organization, or the auditor may perform such procedures.

5.131 The AICPA Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*, provides guidance to service auditors engaged to issue reports on a service organization's controls that may be part of a user organization's information system in the context of an audit of financial statements, and to user auditors engaged to audit the financial statements of entities that use service organizations.

Considerations for Integrated Audits

When performing an integrated audit, refer to paragraphs B18–B29 of Appendix B, *Additional Performance Requirements and Directions; Extent-of-Testing Examples*, of AU section 320 of PCAOB Standards regarding the use of service organizations.

^{hh} AU section 324 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

Tests of Controls

5.132 Regulatory requirements have a major effect on the audit of a broker-dealer because the auditor is required to issue a report on the adequacy of the broker-dealer's internal control in accordance with SEC Rule 17a-5(g)(1) and on its compliance with specific rules addressing financial responsibility and recordkeeping. Accordingly, some tests of controls are normally performed even if the auditor does not rely on internal control for purposes of rendering an opinion on the financial statements.

5.133 Auditors of broker-dealers that are issuers are also required to audit and report on management's assessment of the company's internal control over financial reporting in conjunction with their audit of the company's financial statements in accordance with AU section 320 of PCAOB Standards. As discussed in paragraph 5.01, this Guide is not intended to provide guidance to auditors on how to comply with the requirements of AU section 320 of PCAOB Standards although it highlights, as appropriate, additional requirements imposed by that standard.

Omnibus and Fully Disclosed Accounts

5.134 The following paragraphs provide a discussion of certain unique auditing procedures that should be performed for omnibus and fully-disclosed accounts.

Omnibus Accounts

5.135 *Carrying Broker.* A broker-dealer may perform clearing functions for other brokers (the initiating or introducing brokers). Such transactions are recorded in accounts designated as omnibus or fully disclosed accounts. The auditor should confirm material balances in omnibus accounts. The broker-dealer should explain any differences that exist between the books and confirmation responses, and reconciling items should be traced to supporting documentation. The auditor should test the clearing broker's segregation, transfer, and cashiering operations and controls pertaining to transactions of the initiating broker, to determine that the instructions of the initiating broker were carried out on a timely basis, in compliance with their agreement, and in accordance with the prescribed rules and regulations of applicable regulatory agencies. In addition, the auditor may want to trace selected trades in the omnibus accounts to underlying documentation furnished by the initiating broker and test that the clearing fee is in conformity with the applicable agreement.

5.136 *Introducing Broker.* The balance in the omnibus account should be confirmed with the clearing broker. The auditor should trace any difference between the confirmation response and the client's records to underlying documentation. In addition, the auditor should consider testing the computation of the clearing fee for compliance with the related agreement and should consider the introducing broker-dealer's obligations pursuant to the clearing agreement as to guaranteeing the deficits of its introduced customers.

Fully Disclosed Accounts

5.137 *Carrying Broker.* Because the accounts of the introducing broker's customers are maintained on the books of the carrying broker, as if they were

customers of the carrying broker, the auditing procedures for those accounts are the same as those performed on other customers' accounts. In addition, the auditor should consider testing the fees earned for carrying the other broker's accounts.

5.138 *Introducing Broker.* The auditor should determine that the introducing broker is credited with the agreed-on fee for trades generated by its customers. There should be tests of the introducing broker's system to verify that all trades were executed in accordance with its instructions and that fees comply with the applicable agreement. Such tests would ordinarily include comparing daily trading activity summaries prepared by the carrying broker with memorandums of the introducing broker. In addition, the auditor should consider testing the computation of the clearing fee for compliance with the related agreement and should consider the introducing broker-dealer's obligations pursuant to the clearing agreement as to guaranteeing the deficits of its introduced customers.

5.139 When auditing the omnibus account of an initiating broker or the fully disclosed accounts of an introducing broker, the auditor should consider the relationship with and financial viability of the clearing or carrying broker, respectively, and should consider obtaining from management the report on internal control filed by the clearing or carrying broker with the SEC. The auditor should also consider whether, under the guidelines of AU section 324,^{hh} it would be best to request a service auditor's report from the clearing or carrying broker.

Substantive Audit Procedures

5.140 Certain auditing procedures unique to an audit of a broker-dealer are discussed in the following paragraphs. The chart beginning at the end of this chapter provides illustrations of audit assertions, audit objectives, and substantive tests. In addition, there are other auditing procedures that need to be performed in the audits of broker-dealers that are not unique to such audits or that do not require special application in them. Such procedures are not discussed in this chapter and the auditors should refer to other sources for those requirements.

Securities Record

5.141 The specific audit objective related to the securities record is to determine that positions are in balance (meaning that total long positions equal total short positions). Verifying that a balanced securities record exists is similar to verifying that the trial balance balances. It provides evidence of completeness and acts as a reference tool for audit procedures applied to accounts with securities positions and as additional assurance that general ledger account balances are accurate.

5.142 The auditor generally tests the securities record to ensure that positions are in balance and to test the balancing of selected items. Audit evidence for stock record positions may be obtained by physical inspection, through confirmation, or by a combination of both.

^{hh} See footnote hh in paragraph 5.129.

Securities in Physical Possession

5.143 The auditor would normally account for securities in physical possession by counting them or by observing and testing the broker-dealer's procedures for physical inspection as part of the quarterly security count requirements of SEC Rule 17a-13.

5.144 If the auditor observes the broker-dealer's security count, he or she should—

- Consider whether procedures employed result in a complete and accurate count.
- Review the procedures used and the execution of those procedures.
- Perform test counts, to the extent necessary, and follow-up procedures to clear exceptions.

5.145 If the securities on hand are tested at interim dates, the auditor may want to be involved in the quarterly count made on the date closest to the date of the financial statements. This involvement could be limited to discussions with the broker-dealer and to a review of the procedures to be followed during the count to determine whether they are consistent with those that the auditor has previously reviewed, tested, and *determined to be reasonable*.

5.146 Depending on the significance of the security count (considering the volume of securities on hand or the involvement of internal auditors), the auditor may want to be present during portions of the count to be satisfied that those procedures are being followed and that there has been no change from the procedures tested. The auditor should be familiar with the guidance provided by AU section 322 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*) and AU section 313 (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*).

5.147 The auditor should inquire about the results of the security count and determine whether there are any material unresolved differences. If there are such differences, the auditor should be *satisfied, to the extent he or she considers necessary, concerning the reason, nature, and ultimate disposition of the differences and their effect on the financial statements and other regulatory reporting requirements*.

Securities in for Transfer, Exchange, or Redemption

5.148 A broker-dealer, particularly one that engages in a substantial volume of transactions, may have a separate transfer department or division to handle securities held for transfer.

5.149 Securities out for transfer may be audited, to the extent the auditor deems necessary, by direct correspondence with the transfer agents or the corporate issuers or by physical inspection of the securities when they are returned to the broker-dealer. In determining the procedures to be applied, the auditor should consider the extent to which transfers are being processed through a depository or, if they are being processed by a transfer agent, the length of time that such items have been in transfer. An audit of the securities when they are

returned implies that it is reasonable to assume that such returns suggest that the securities were held by the transfer agent on the date being tested.

Securities Serviced at Depositories

5.150 The auditor should consider confirming directly with depositories and clearing organizations security positions serviced on behalf of the broker-dealer as of the date of the security count. The broker-dealer should prepare a reconciliation of positions serviced by these organizations, which the auditor should test by comparing it to the statement received directly from the organizations.

5.151 For the continuous net settlement accounts, there is a direct relationship between the net market value of the securities to be settled and the money to be settled. This relationship should be reviewed, and any differences should be explained. Because most of the securities serviced by broker-dealers will be located at depositories, the auditor needs to consider internal control in effect at such organizations. The auditor may do so by obtaining the most recent report issued by that organization's independent auditors on the organization's internal control (see AU section 324^{hh}).

Securities Failed to Receive and Failed to Deliver, Securities Borrowed and Loaned, Securities Held Under Repos and Reverse Repos, and Securities Held as Collateral for Bank Loans

5.152 The auditor would normally test the positions of securities failed to receive, failed to deliver, borrowed and loaned, held under repos and reverse repos, and held as bank loan collateral through confirmation with the other party to the transaction. The extent of the confirmation procedures should be based on the following:

- The auditor's judgment concerning internal control
- The size of the accounts
- The relationship of money balance to security value
- The types of error or fraud that have occurred

Securities Held by Branch Office

5.153 The auditor should inquire about securities held by branch offices and, if they are material, should consider whether he or she should inspect them in coordination with the inspection at the main office. Otherwise, the auditor should determine whether a review of the broker-dealer's procedures for controlling and accounting for securities at branch offices would be sufficient.

Considerations for Integrated Audits

When performing an integrated audit, the auditor should refer to Appendix B, "Additional Performance Requirements and Directions; Extent-of-Testing Examples," of AU section 320 PCAOB Standards for discussion of considerations when a company has multiple locations

^{hh} See footnote hh in paragraph 5.129.

or business units. (*Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2*, AU secs. 312.18 and 319.09)

Securities Position Differences

5.154 All differences disclosed through the comparison of counts and confirmations with the records of the broker-dealer should be resolved by the broker-dealer, and adjustments should be reviewed by the auditor to the extent considered necessary.

Customers' Accounts (Including Partners, Officers, Directors, Employees, and Shareholders)

5.155 The auditor should normally confirm account positions and balances. Sampling techniques may be suitable if there are many accounts. In selecting customers' accounts for confirmation, the auditor needs to consider the value of the security positions in such accounts, as well as the ledger (money) balances; the auditor should also consider confirming some accounts with zero balances. AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), provides guidance to the auditor on using confirmations.

5.156 The broker-dealer might, for its own purposes, request that the auditor extend the confirmation of customers' accounts beyond those necessary for purposes of the audit. In those cases, the auditor should consider the implications on his or her auditing procedures of misstatements discovered in performing the additional confirmations at the request of the client.

5.157 The auditor should also review customers' accounts for evidence of undermargined, partly secured, or unsecured conditions that may affect the net capital computation under SEC Rule 15c3-1 and the reserve and possession-or-control requirements of Rule 15c3-3, as well as the collectibility of accounts. In performing such a review, it may be helpful to obtain an equity run, which is a report that indicates, for each customer's account, the ledger balance and the market values of all securities positions in the account. In performing audit procedures in the customer area, the auditor should review the broker-dealer's practices and procedures that are established to comply with Regulation T and SEC Rules 15c3-1 and 15c3-3.

Trading and Investment Accounts

5.158 The auditor should ascertain that the trading department position records are in agreement with or have been reconciled to the stock record and that accruals for profit or loss on the broker-dealer's inventory positions related to unsettled trades are made. For further details, see Chapter 7, "Accounting Standards," the section entitled "Trade-Date Versus Settlement-Date Accounting." In addition, the auditor should test, if material, the values of such securities and all pricing sources should be indicated in the audit documentation. Quotations for exempted securities and securities not actively traded may be obtained from the trading department of the broker-dealer being examined; however, the auditor should test material items independently with other broker-dealers that have knowledge of the particular security or with other

appropriate sources. The sources of the market price quotations used should be documented.

5.159 For securities with no ready market, the auditor does not function as an appraiser and is not expected to substitute his or her judgment for that of the management of the broker-dealer in determining value; rather, the auditor should review the information relied on by management and determine whether the procedures followed are reasonable in the circumstances. If management or its pricing service uses a formula-based pricing or a similar method, the auditor's understanding of the procedures should be sufficient to satisfy him or her that the procedures produce a reasonable determination of value.

5.160 The auditor should perform those test calculations that he or she deems necessary in the circumstances. As partial substantiation for the valuation of such securities, the auditor may also wish to review purchases or sales made shortly before and after the valuation date being tested. The auditor may also request a valuation from other broker-dealers or from independent pricing services.

5.161 Management's valuation procedures of securities that are not readily marketable are designed to approximate the fair value. Those procedures are generally a good-faith estimate by management. If the auditor concludes that the procedures used to estimate value are reasonable and the documentation is appropriate, the opinion need not be modified. However, should the auditor conclude otherwise, the opinion should be modified.

5.162 AU section 328^{cc} provides guidance on auditing fair value measurements and disclosures contained in financial statements. Under AU section 328,^{cc} the auditor's substantive tests of fair value measurements involve (a) testing management's significant assumptions, the valuation model, and the underlying data, (b) developing independent fair value estimates for corroborative purposes, or (c) examining subsequent events and transactions that confirm or disconfirm the estimate. AU section 332,ⁱⁱ among other matters, provides guidance to auditors in planning and performing auditing procedures for assertions about investments in securities that are made in an entity's financial statements. A companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides practical guidance for implementing AU section 332.ⁱⁱ For audits conducted in accordance with GAAS, AU sections 9328 and 9332 (AICPA, *Professional Standards*, vol. 1) provide that if the auditor determines that the nature and extent of auditing procedures should include tests of the measurement of investments in securities (or interests in a trust that holds investments in securities), simply receiving a confirmation from a third party (including a trustee) does not, in and of itself, constitute adequate audit evidence with respect to the valuation assertion. The interpretations also provide that receiving confirmation from a third party (including a trustee) for investments in aggregate does not constitute adequate audit evidence with respect to the existence assertion. Receiving confirmation from a third party (including a trustee) on a security-by-security or investment-by-investment basis, however, typically would constitute adequate audit evidence with respect to the existence assertion.

^{cc} See footnote cc in paragraph 5.94.

ⁱⁱ AU section 332 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

Good-Faith Deposits

5.163 Normally, good-faith deposits accompany bids to purchase new issues of securities. The deposit and the related commitment can normally be confirmed at the same time. The broker-dealer may be acting as the manager of a group making a bid for a new issue of securities; in such cases, the other participating members usually deposit proportionate amounts of the required deposit with the managing dealer. The auditor may request that the participants confirm in writing the amount of their deposits.

Subordinated Accounts and Borrowings

5.164 The auditor should obtain satisfaction concerning cash subordination or secured demand note agreements and determine whether they have been approved by the appropriate regulatory bodies. That may be done through direct confirmation. The auditor should also determine, through confirmation, the expiration dates of the agreements, the amounts subordinated, any collateral, any limits in relation to those amounts, and the nature of the liability to the subordinating party. In addition, the auditor should determine whether the broker-dealer is in compliance with any restrictive covenants contained in the subordination agreement. This information is needed to determine the proper carrying value of the accounts and the appropriate treatment under net capital rules.

Dividends Receivable or Payable

5.165 Dividends receivable in cash or securities should be analyzed and reviewed for age and collectibility, and those that are material in amount may be confirmed, as deemed necessary. The auditor should review the procedures for recording dividends receivable and payable to determine the extent of material unrecorded amounts.

Unclaimed Dividends, Coupons, and Securities

5.166 The auditor should review the procedures followed by the broker-dealer for recording material transactions in accounts for unclaimed dividends, coupons, and securities. Detailed accounts maintained for unclaimed items should be compared with control accounts. Charges against unclaimed items can be examined on a selected basis and compared with claims or correspondence, particularly charges against older items. The auditor should review the broker-dealer's procedures for determining its compliance with state laws. Market action affecting underlying items may give rise to contingent liabilities and net capital charges, and such activity should be reviewed.

Exchange Memberships

5.167 The ownership of exchange memberships can be confirmed through direct correspondence with the exchange. It is not unusual for a broker-dealer to have more than one membership on a particular exchange. The propriety of considering exchange memberships as assets of the broker-dealer should be ascertained by referring to partnership agreements or other documents of the broker-dealer. The auditor should also be satisfied concerning the propriety of the carrying value of the memberships and whether the carrying value has been

impaired. Due to the demutualization of some exchanges, membership may not be aligned with ownership in the exchange. In a demutualization, trading privileges are disaggregated from ownership and valuation of memberships and other forms of ownership/trading privileges should be carefully evaluated.

Open Contractual Commitments

5.168 The auditor may wish to confirm contractual commitments (other than endorsed puts and calls, the holders of which are unknown) on a test basis. In many cases, the commitments of customers will appear in their accounts and will be confirmed when those accounts are confirmed. In other cases, information concerning purchases and sales of securities on a when-issued or when-distributed basis may not appear in the customers' accounts or in the stock record, but may be maintained instead in a subsidiary record (such as tickets in an open contract file). In such cases, the open contracts may be confirmed in the same manner as are other accounts.

5.169 Sometimes, if a settlement date (subsequent to the date of the financial statements) has been fixed for an open contract transaction, the broker-dealer will clear the open contract file and enter the transactions on the settlement blotter for the day of settlement. Such transactions are not regular-way transactions and may be confirmed separately.

5.170 Another type of contract involves the broker-dealer's interest in joint accounts in issued or to-be-issued securities carried by other broker-dealers. In many cases, the interest in those security positions contained within the accounts is not recorded in the general ledger of the noncarrying member of the joint account. In such cases, an adjustment is usually recorded in the trial balance to reflect such accounts in the financial statements. Details of the joint accounts may be confirmed in writing with the carrying broker-dealers to the extent the auditor considers necessary.

5.171 Broker-dealers that engage in underwriting securities for issuers may incur an open contractual commitment in the event the firm definitively and conclusively agrees or contracts to underwrite an issuer's securities prior to its offering. Typically, this type of commitment occurs immediately prior to the offering. However, broker-dealers may enter into a contract with an issuer that provides a "firm commitment" to underwrite securities several days or weeks prior to the actual offering. Auditor may wish to look at a broker-dealer's underwriting function to ensure the identification and proper recording, including regulatory capital charges, of any underwriting open contractual commitments.

Private Placements

5.172 The audit of private placement transactions may include a review with management of agreements between the broker-dealer and entities for which debt or equity securities have been placed. The auditor should review the status of the individual contracts to determine any existing broker-dealer obligations that may require disclosure in the financial statements. In addition, the auditor should consider confirming outstanding contractual agreements offsetting customers' commitments to purchase such securities.

Mutual Funds

5.173 Procedures for testing mutual fund transactions will differ depending on the amount of activity and the method of accounting for customer

purchases and redemptions. Few auditing procedures are necessary in cases in which the broker assists a customer in the purchase or redemption of mutual fund shares in the name of the customer. However, if a broker-dealer, acting in a custodial capacity for customers, maintains an active account in its name with one or more mutual funds, certain procedures should be considered, including confirming the number of shares held by the mutual funds in the name of the broker-dealer and comparing those quantities to safekeeping records of the broker-dealer. The auditor may consider testing the accrual of 12b-1 fees, as well as the methodology used in deferring and amortizing deferred sales charges, by reviewing the broker-dealer's control over customer-owned mutual fund shares that it has sold. Depending on the materiality of open purchases or redemptions, those amounts may also be confirmed.

Municipal Refunding Bond Underwritings

5.174 The auditor's objectives in examining municipal refunding bond underwritings should be similar to those for regular underwritings and open contractual commitments. However, the auditor should also determine that the broker-dealer has met its commitment to the issuer to purchase U.S. government securities that are to be placed in escrow. Often, U.S. government securities may not be available in the quantities desired or at the same price as anticipated at the time the underwriting agreement was executed. In such cases, the broker-dealer may sustain losses in satisfying its obligation to the issuer. These losses should be recorded in the accounts.

Suspense Accounts

5.175 The purchase and sales and the operations suspense accounts should be analyzed at the end of the period, and these amounts should be charged to income or expense or reclassified as appropriate to accounts such as inventory, customer, receivable, or payable or to other accounts for financial reporting purposes. The auditor should review the analysis for propriety of aging and classification, and might also test specific items by confirmation with third parties, comparison with underlying records, or other procedures.

Computation of Formula for Determination of Reserve Requirement, Possession or Control of Securities, and Net Capital

Reserve Requirement and Possession or Control of Securities

5.176 SEC Rule 15c3-3 requires every broker-dealer who carries customer accounts to maintain a "Special Reserve Bank Account for the Exclusive Benefit of Customers" with a bank (at all times when deposits are required). That account should be separate from any other bank account of the broker-dealer and should contain deposits in cash and qualified securities in amounts computed in accordance with the formula attached in Exhibit A of SEC Rule 15c3-3.

5.177 Rule 15c3-3 provides a detailed formula for determining the reserve bank account requirement and designates when such computations must be made. The rule also requires a broker-dealer to promptly obtain physical possession or control of all fully paid securities and excess-margin securities carried for the accounts of customers, and it requires the broker-dealer to act

within a specified time period when possession or control has not been established.

5.178 The auditor should review the broker-dealer's procedures and controls required by SEC Rule 15c3-3 and should perform those tests considered necessary to be satisfied that the procedures and controls (including the written documentation) provide reasonable assurance that the broker-dealer is in compliance with the rule.

Net Capital

5.179 SEC rules require all registered broker-dealers to comply at all times with the net capital requirements and to calculate net capital on a periodic basis to demonstrate compliance. *Net capital* is the broker-dealer's net worth, including allowable subordinated liabilities and other credits adjusted for nonliquid (nonallowable) assets, capital charges for operational items, and possible adverse fluctuations in the value of inventory (haircuts). The purpose of the net capital computation is to determine the broker-dealer's net liquid assets (minimum capital base) in the event of adverse business conditions. This minimum capital base is designed to protect (a) customers, (b) creditors, and (c) other broker-dealers.

5.180 The auditor should review the broker-dealer's procedures and controls covered by SEC Rule 15c3-1 and should perform those tests considered necessary to be satisfied that the procedures and controls, including the written documentation, provide reasonable assurance that the broker-dealer is in compliance with the rule. If appropriate, the auditor should also consider the effect on the supplemental schedules of differences identified as a result of the audit of the basic financial statements. See paragraphs 4.15 and 4.16.

Securities Broker-Dealers' Auditing Considerations⁶

Examples of Substantive Tests and Tests of Control

Audit Objectives

Audit Assertions

Audit Areas

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Cash/Drafts Payable	Validity/Completeness	Balances in cash (including segregated funds) and drafts payable accounts are fairly stated.	<ul style="list-style-type: none"> ● Confirm balances (including accounts with zero balances). ● Confirm compensating balance arrangements. ● Test reconciliations. ● Obtain subsequent bank statements and determine that transactions were recorded in the proper period.
	Recording	Controls over cash receipts and disbursements are sufficient	<ul style="list-style-type: none"> ● Test compliance with controls including the following: <ul style="list-style-type: none"> — Daily cash balancing procedures — Segregation of duties (for instance, independent reconciliation procedures, authorization, and controls over disbursements, including check and wire transfers). — Periodic independent reconciliation of accounts.
	Valuation	Reserves are adequate to cover exposure resulting from aged reconciling debit items.	<ul style="list-style-type: none"> ● Perform analytical procedures on aged reconciling items. ● Understand reserve policy ● Determine that reserves are sufficient relative to exposures related to aged reconciling items. ● Obtain and test cash concentration procedures.
	Presentation	Cash (including segregated funds) and drafts payable are properly classified in the financial statements.	<ul style="list-style-type: none"> ● Determine the appropriateness of financial statement presentation and related disclosures: <ul style="list-style-type: none"> — Drafts payable and cash accounts are only netted when right of setoff exists. — Cash segregated for regulatory purposes is correctly disclosed. — Marketable securities that are classified as cash equivalents satisfy the requirements for such classifications.
	Cutoff	Cash- and drafts - payable balances reflect transactions recorded in the proper period.	<ul style="list-style-type: none"> ● Obtain a schedule of deposits made prior to year-end but not recorded until subsequent year-end. Agree items to year-end bank reconciliation. Items should appear as reconciling items ● For interbank transfers, ascertain that receipts and corresponding disbursements are both entered in cash records in the same period, noting dates of deposits and dates transfer checks were down.

⁶ AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), provides guidance on auditing fair value measurements and disclosures contained in financial statements. AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, Securities (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities, and investments in securities. In addition, a companion Audit Guide, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides practical guidance for implementing AU section 332.ⁱⁱ Practitioners should refer to the auditing considerations contained in the AU sections referred to above and the companion Audit Guide for guidance on audit assertions, audit objectives, tests of controls, and substantive tests related to investments in securities, derivative instruments, and hedging activities. For audits conducted in accordance with GAAS, AU sections 9328 and 9332 (AICPA, *Professional Standards*, vol. 1) provide that if the auditor determines that the nature and extent of auditing procedures should include tests of the measurement of investments in securities (or interests in a trust that holds investments in securities), simply receiving a confirmation from a third party (including a trustee) does not, in and of itself, constitute adequate audit evidence with respect to the valuation assertion. The interpretations also provide that receiving confirmation from a third party (including a trustee) on a security-by-security or investment-by-investment basis, however, typically would constitute adequate audit evidence with respect to the existence assertion. Receiving confirmation from a third party (including a trustee) on a security-by-investment or investment-by-investment basis, however, typically would constitute adequate audit evidence with respect to the existence assertion.

ⁱⁱ See footnote ii in paragraph 5.162.

Bank Loans	Validity/ Completeness	All bank loans have been identified and fairly stated	<ul style="list-style-type: none"> ● Confirm balances (including accounts with zero balances and collateral pledged). ● Confirm letter-of-credit agreements. ● Test reconciliations of bank statements to company records. ● Obtain subsequent bank statements and determine that loans were recorded in the proper period.
	Presentation	Bank loans are properly classified in financial statements	<ul style="list-style-type: none"> ● Determine the appropriateness of financial statement presentation and related disclosures: <ul style="list-style-type: none"> — Bank loan balances are properly classified. — Letters of credit and assets pledged are properly reported.
	Cut-off	Bank loan balances are recorded in the proper period	<ul style="list-style-type: none"> ● Obtain and test interbank transfers and subsequent payments.
Customer Receivables and Payables	Validity/ Completeness	Customer-receivable and customer-payable amounts are fairly stated.	<ul style="list-style-type: none"> ● Confirm selected customer account balances and positions through either positive or negative requests or a combination of both: <ul style="list-style-type: none"> — With positive confirmations, follow up with second requests for customer accounts not replying. — Follow up on the resolution of exceptions. ● Perform analytical procedures on balances by account type, such as DVP/RVP versus hold/custody accounts and margin versus cash accounts.
		Controls over customer receivables and payables are sufficient.	<ul style="list-style-type: none"> ● Test compliance with controls, including the following: <ul style="list-style-type: none"> — For openings of new accounts, appropriate customer approvals are obtained (for example, hypothecation loan agreement for margin accounts.) — Trading and other activity in customer accounts are adequately monitored to ensure that unauthorized transactions are detected. — Transactions recorded in no-name (invalid) accounts are adequately monitored and resolved on a timely basis. — Procedures for monitoring trades and journal entries at branch offices are in effect. — Controls over changes to the name and address file are adequate. — Hold-all-mail (<i>holdout</i>) statements are supported by valid customer instructions. — Procedures for monitoring and resolving error statements are adequate. — Procedures for abandoned property accounts and compliance with state escheat laws are adequate. — Procedures for monitoring and resolving customer complaints are adequate. — Employee accounts are properly identified, monitored, and reported. — Customer statements are periodically mailed.
	Recording	Trades are inputted timely and accurately.	<ul style="list-style-type: none"> ● Determine that order matching procedures are adequate. ● Determine that trade confirmations are sent to customers on a timely basis. ● Test selected accounts for as-of-trades.

(Continued)

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
	<p>Valuation</p>	<p>Reserves are properly established to adequately reflect exposure from uncollectible receivables (debit balances plus short market value is greater than credit balances and long market value.</p>	<ul style="list-style-type: none"> ● Analytically determine exposure and reserve amounts for undermargined, partly secured, and unsecured customer accounts. ● Obtain reserve policy and determine compliance. ● Determine that reserves are sufficient relative to exposure.
	<p>Presentation</p>	<p>Customer-receivable and customer-payable amounts are properly classified in the financial statements.</p>	<ul style="list-style-type: none"> ● Determine the appropriateness of financial statement presentation and related disclosures: <ul style="list-style-type: none"> — Amounts are appropriately classified. — Customer receivables and customer payables are shown gross. — Allowance for doubtful accounts is disclosed.
	<p>Cutoff</p>	<p>Customer transactions are accurately recorded in the appropriate period.</p>	<ul style="list-style-type: none"> ● Understand internal procedures associated with processing customer transactions. ● Confirm selected customer account balances and positions.
<p>Receivables from/ Payables to Brokers and Dealers</p>	<p>Validity/ Completeness</p>	<p>Receivables from and payables to brokers and dealers are fairly stated.</p>	<ul style="list-style-type: none"> ● Confirm, for selected counterparties, open fail-to-receive and fail-to-deliver transactions and resolve all exceptions. ● Confirm, balances in omnibus accounts for clearing and initiating brokers and resolve all exceptions. ● Perform analytical procedures on fail balances by counterparty and product type (equities, corporate bonds, and so forth.) ● Vouch documentation supporting the subsequent settlement of open transactions.
	<p>Controls over the clearance, settlement, balancing, and reconciliation of transactions are sufficient.</p>	<p>Controls over the clearance, settlement, balancing, and reconciliation of transactions are sufficient.</p>	<ul style="list-style-type: none"> ● Test compliance with controls, including the following: <ul style="list-style-type: none"> — Comparison and reconciliation procedures with custodian and clearing organizations such as the DTC, NSCC, and OCC. — Reconciling pending and settled trades. — Resolving uncomparared trades. — Aging of open items — Identifying, monitoring and reporting exposure items.
	<p>Reconciliations of subsidiary fail blotters to the general ledger and securities record are prepared completely and accurately, and are timely; and out-of-balances are researched and resolved timely.</p>	<p>Reconciliations of subsidiary fail blotters to the general ledger and securities record are prepared completely and accurately, and are timely; and out-of-balances are researched and resolved timely.</p>	<ul style="list-style-type: none"> ● Test reconciliations: <ul style="list-style-type: none"> — Agree total position and money to stock record and trial balance. — Determine the resolution of reconciling items.
	<p>Money and securities received/delivered do not differ for recorded amounts.</p>	<p>Money and securities received/delivered do not differ for recorded amounts.</p>	<ul style="list-style-type: none"> ● Test house balancing procedures by comparing recorded cash activity and securities movements with banks and depositories to actual activity and movements.
	<p>Reserves are properly established to adequately reflect exposure, that is, debit is greater than long market value (LMV) and short market value (SMV) is greater than credit.</p>	<p>Reserves are properly established to adequately reflect exposure, that is, debit is greater than long market value (LMV) and short market value (SMV) is greater than credit.</p>	<ul style="list-style-type: none"> ● Test procedures for determining exposure to loss. ● Perform analytical procedures on aged items. ● Obtain reserve policy and determine compliance. ● Determine that reserves are sufficient relative to exposure.

Presentation	Receivables from and payables to brokers and dealers are properly classified in the financial statements.	<ul style="list-style-type: none"> ● Determine the appropriateness of financial statement presentation and related disclosures: <ul style="list-style-type: none"> — Amounts are properly classified. — Amounts are appropriately shown gross. ● Determine that all trade date adjustments are appropriately recorded. ● Vouch subsequent receipts to customer statement on a test basis.
Cutoff	Receivables from and payables to brokers and dealers are accurately recorded in the appropriate period.	<ul style="list-style-type: none"> ● Confirm selected open transactions by counterparty for money and related securities positions and resolve all exceptions. ● Confirm noncash borrow/loan (meaning, securities for securities).
Validity/ Completeness	Securities loaned and securities borrowed are fairly stated.	<ul style="list-style-type: none"> ● Test compliance with controls, including the following: <ul style="list-style-type: none"> — Procedures for processing, settling, balancing, and reconciling regular and matched-book securities borrowed/loaned transactions. — Comparison procedures with LOANET (see the Glossary) — Procedures related to credit review policies. ● Test reconciliations: <ul style="list-style-type: none"> — Agree total position and money to stock record and trial balance. — Scan the resolution of out-of-balances and reconciling items.
Controls over Securities Borrowed and Loaned	Controls over securities borrowed and loaned are sufficient.	<ul style="list-style-type: none"> ● Test house balancing procedures. Compare recorded cash activity and securities movements with banks and depositories to actual activity and movements. ● Test the mark-to-market and collection procedures for additional margin requirements. ● Test procedures for determining exposure to loss. ● Determine that noncash collateral received in exchange for securities loaned is properly valued. ● Obtain reserve policy and test compliance. ● Determine that reserves are sufficient relative to exposure.
Reconciling	Reconciliations of subsidiary loan/borrow blotters to the general ledger and securities record are prepared completely and accurately, and are timely, and out-of-balances are researched and resolved timely.	<ul style="list-style-type: none"> ● Determine the appropriateness of financial statement presentation and related disclosures: <ul style="list-style-type: none"> — Securities-loaned and securities-borrowed amounts are appropriately classified. — Amounts are shown gross. ● Test listing of securities-borrowed and securities-loaned transactions entered into prior and subsequent to year-end. Determine that transactions are recorded in the proper periods.
Recording	Money and securities received/delivered do not differ from recorded amounts	
Valuation	Collectibility and collateralization of receivables and short positions are adequate.	
Presentation	Reserves are properly established to adequately reflect exposure (that is, debits are greater than LMV and SMV is greater than credits).	
Validity/ Completeness	Securities loan and securities borrowed are properly classified in the financial statements.	
Cutoff	Securities-borrowed and securities-loaned transactions are recorded in the proper period.	

(Continued)

Audit Areas	Audit Assertions	Audit Objectives	Examples of Substantive Tests and Tests of Control
Securities Owned and Sold, Not Yet Purchased	Validity/Completeness	Trade date inventory positions are accurate.	<ul style="list-style-type: none"> ● Perform analytical procedures on account balances by product type. ● Test internal control to ensure that the following: <ul style="list-style-type: none"> — Trader records are reconciled with the general ledger and stock record. — Branch orders are matched with trader order. — Trading limits and concentration restrictions are properly established and monitored. — Trader activity is adequately monitored by management. — When-issued, forward trades, financial futures, and standby commitments are properly monitored and reported.
Recording	Recording	Trades are timely and accurately inputted.	<ul style="list-style-type: none"> ● Determine that trades are properly time-stamped. ● Test select accounts for "as of" trades.
Valuation	Valuation	Trade date inventory is fairly stated at market value.	<ul style="list-style-type: none"> ● Test pricing procedures. ● Agree prices for selected securities to independent sources with emphasis on positions with manual or override prices. Develop alternative procedures to determine the reasonableness of prices if no independent prices are available: examine recent/subsequent trading activity; compare prices to similar securities based on maturity, rating, or other criteria; or revise assumptions used in models. ● Recalculate interest and dividend accruals for selected securities in inventory. ● Test inventory positions for concentrations in particular securities. ● Test aging of inventory.
Rights/Obligations	Rights/Obligations	Reserves are properly established to adequately reflect exposure (that is, debits are greater than LMV and SMV is greater than credits).	<ul style="list-style-type: none"> ● Understand risk management procedures for monitoring overall exposure, including the use of hedges to reduce exposure to market risk. ● Determine that reserves are sufficient relative to exposure.
Presentation	Presentation	Joint inventory positions are properly identified.	<ul style="list-style-type: none"> ● Confirm selected joint inventory positions and test related controls.
		Accruals for inventory positions relating to unsettled trades are properly classified.	<ul style="list-style-type: none"> ● Test controls over the generation of trade and date and settlement date inventory positions. ● Test trade date/settlement date adjustment.
		Inventory positions are properly classified in the financial statements.	<ul style="list-style-type: none"> ● Determine the appropriateness of financial statement presentation and related disclosures; <ul style="list-style-type: none"> ● Securities inventory positions are properly classified as <ul style="list-style-type: none"> ● Securities on deposit in compliance with regulatory requirements. ● Securities owned. ● Securities not readily marketable. ● Securities sold, not yet purchased. ● Joint inventory owned by other brokers and dealers.

Cutoff	Securities owned and securities sold, not yet purchased are accurately recorded in the appropriate period.	<ul style="list-style-type: none"> ● Test "as of" trades subsequent to year end to ensure that they are reflected in the proper period. ● Perform analytical procedures on repo and resale balances and related interest income/expense based on average balances and interest rates. ● Confirm selected open repo and resale transactions by counterparty, based on cash balances and related securities positions, and resolve all exceptions.
Validity/ Completeness	Repurchase (repo) and reverse repurchase (resale) amounts are fairly stated in financial statements.	<ul style="list-style-type: none"> ● Test compliance with controls, including the following: <ul style="list-style-type: none"> — Procedures for processing, settling, balancing and reconciling repo and resale transactions. — Identifying and resolving all out of balances. — Monitoring and reporting aged items. — Procedures related to credit review and collection policies.
Securities Purchased Under Agreements to Resell and Securities Sold Under Agreements to Repurchase	Controls over securities purchased under agreements to resell and securities sold under agreements to repurchase are sufficient.	<ul style="list-style-type: none"> ● Test house balancing procedures; compare anticipated cash activity and securities movements with banks and depositories to actual activity and movements.
Recording	Money and repo and resale positions do not differ from recorded amounts.	<ul style="list-style-type: none"> ● Test procedures for the following: <ul style="list-style-type: none"> — Appropriateness of the market value of collateral positions. — Calculating interest accruals on collateral positions.
Valuation	The collateralization of resales is adequate to cover exposure.	<ul style="list-style-type: none"> ● Obtain reserve policy and determine compliance. ● Determine that reserves are sufficient relative to exposure.
Presentation	Matched book repo and resale agreements are separately disclosed on the statement of cash flows.	<ul style="list-style-type: none"> ● Determine the appropriateness of financial statement presentation and related disclosures: <ul style="list-style-type: none"> — Repurchase and resale amounts are appropriately classified. — Amounts are shown gross, if appropriate. — Matched book transactions are properly recorded. — Amounts are properly classified on the statement of cash flows.
Off-balance-sheet risks are sufficiently disclosed	Securities purchases under agreements to resell and securities sold under agreements to repurchase are recorded in the proper period.	<ul style="list-style-type: none"> ● Determine the appropriateness of financial statement presentation and related disclosures. ● Test procedures and controls over the processing of resale and repo transactions, which will include cash and security movements, segregation procedures, and balancing. ● On a test basis, sample these items, determining if the transaction was recorded in the proper period.
Cutoff		

(Continued)

<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Suspense and Processing Accounts	Validity/Completeness	Suspense and processing amounts are fairly stated.	<ul style="list-style-type: none"> ● Perform analytical procedures on suspense account positions, money balances, and exposure amounts. ● Understand controls for processing the following: <ul style="list-style-type: none"> — Cash receipts and disbursements and securities movements from cash and box accounts with customer accounts and other general ledger accounts, such as fail and offset accounts. — Transactions in equities, fixed income, mutual funds, and foreign securities. — Assignment and exercising of options. — Conversion of foreign currency balances into U.S. dollars. — Intercompany transactions. — Unidentified and miscellaneous transactions.
		Controls regarding procedures for researching and resolving items in suspense accounts on a timely basis are sufficient.	<ul style="list-style-type: none"> ● Determine the appropriateness of procedures for moving money and securities positions into suspense accounts; <ul style="list-style-type: none"> — Test the reconciliation of suspense accounts — Test the resolution of selected suspense items. ● Understand procedures for monitoring and reporting the aging of suspense items. ● Test procedures for identifying and resolving money balances and positions in invalid accounts.
	Valuation	Reserves are established to adequately reflect exposure (money and position) based on the nature and aging of individual suspense items.	<ul style="list-style-type: none"> ● Monitor the periodic reduction of suspense-related exposure items. ● Determine that reserves are sufficient relative to exposure.
	Presentation	Suspense and processing accounts are properly classified in the financial statements.	<ul style="list-style-type: none"> ● Determine the appropriateness of financial statement presentation and related disclosures. ● Test the classification of suspense and processing account balances.
Reorganization Accounts	Validity/Completeness	Reorganizations are properly identified	<ul style="list-style-type: none"> ● Intercompany transactions are properly eliminated for financial statement purposes. ● Perform analytical procedures on reorganization-related positions, money, and exposure amounts ● Test compliance with internal controls, including the following: <ul style="list-style-type: none"> — Procedures for processing, balancing, and reconciling reorganization account. — Proper notification of customers.
	Recording	Reorganization money and positions do not differ from recorded amounts.	<ul style="list-style-type: none"> ● Test house balancing procedures; compare anticipated cash activity and securities movements with banks and depositories versus actual activity and movements.

Valuation	<p>Controls are adequate over the reconciliation of reorganization accounts, including the identification of conversion, ratio out-of-balance conditions.</p> <p>Reserve amounts are sufficient relative to exposure resulting from suspense related and aged items.</p>	<ul style="list-style-type: none"> ● Test controls over the reconciliation of reorganization accounts. ● Test individual reorganizations for timely notification, proper processing of securities movements, and customer-related receipts/disbursements. ● Determine the appropriateness of conversion ratios for selected reorganizations to independent sources. ● Confirm selected reorganization transfers and test the related aging of these items. ● Calculate exposure and monitor the reduction of such exposure. ● Test the determination of exposure for ratio out-of-balance conditions in reorganization accounts. ● Discuss pending litigation relating to missed tender offers with client's counsel. ● Determine that reserves are sufficient relative to exposure. ● Determine the appropriateness of financial statement presentation and related disclosures.
Presentation	<p>Reorganization-related amounts are properly classified in the financial statements.</p>	<ul style="list-style-type: none"> ● Perform analytical procedures on deferred debits/credits and good-faith deposit amounts. ● Test compliance with controls for the following: <ul style="list-style-type: none"> — Expensing or recognizing deferred debits (expenses) and credits (revenues) on underwriting deals. — Performing final accountings on underwriting deals. — Communicating significant information relating to pending deals to the accounting department. — Allocating and recording expenses to be charged to syndicate members. ● Test selected deals recorded immediately before or after year-end to determine that the proper cutoff has been accomplished. ● Confirm selected good-faith deposits and resolve exceptions.
Deferred Investment Banking Revenues and Expenses/Good Faith Deposits	<p>Deferred revenues, expenses and good-faith deposits from investment banking/underwriting deals are recorded in the proper period.</p>	<ul style="list-style-type: none"> ● Test the aging of deferred debits. ● Test selected items for propriety. ● Obtain reserve policy and determine compliance. ● Determine the adequacy of reserves.
Valuation	<p>Deferred debits and credit are properly aged.</p> <p>Reserves are properly established relative to exposure.</p>	<ul style="list-style-type: none"> ● Test procedures for performing final accounting on underwriting deals, including revenue and expense allocations and the timeliness of their procedures. ● Test procedures for communicating significant information relating to pending deals to the appropriate financial units.
Cutoff	<p>Revenues and expenses related to investment banking activity are recorded in the proper period.</p>	<ul style="list-style-type: none"> ● Test selected items for propriety. ● Obtain reserve policy and determine compliance. ● Determine the adequacy of reserves.

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<i>Audit Areas</i>	<i>Audit Assertions</i>	<i>Audit Objectives</i>	<i>Examples of Substantive Tests and Tests of Control</i>
Dividend and Interest Receivables/Payables	Validity/Completeness	Dividend and interest receivables/payables are fairly stated.	<ul style="list-style-type: none"> ● Perform analytical procedures on dividend and interest receivable/payable amounts. ● Understand the compliance with controls over recording, collecting, and disbursing dividends and interest to firm and customer accounts. ● Test the resolutions of selected dividend (stock and cash) and interest receivable and payable amounts by monitoring subsequent collections and payments. ● Test procedures for complying with state escheat laws.
	Recording	Notification of dividends are properly detected, and only authorized transactions are recorded.	<ul style="list-style-type: none"> ● Test controls related to— <ul style="list-style-type: none"> — Accurately recording dividend and interest accruals on record date, and payments on pay date. — Identifying and recording unannounced dividends received.
	Valuation	Cash and stock dividend and interest receivables are properly aged, and reserves that adequately reflect exposure are established.	<ul style="list-style-type: none"> ● Test selected items for propriety to ensure that only authorized dividend and interest transactions are processed (that is, exclude customers who will receive payments directly from the paying agent). ● Perform analytical procedures on aged items. ● Test procedures for aging dividends and interest items and determining collectibility. ● Determine that reserves are sufficient relative to exposure. ● Determine the appropriateness of financial statement presentation and related disclosures. <ul style="list-style-type: none"> — Dividend and interest amounts are properly classified.
	Cutoff	Dividends and interest receivables and payables are recorded in the proper period.	<ul style="list-style-type: none"> ● Test procedures for recording dividends and interest receivables and payables. ● Test that the amounts recorded for dividends and interest are recorded in the proper period by recalculating scotch dividends and bond interest on test basis and agreeing those amounts to the general ledger.
Securities Locations:	Validity/Completeness	Positions listed on the securities record as physically on hand, at depositories, at custodians, or at transfer agents are accurate.	<ul style="list-style-type: none"> ● Test the periodic count of securities on hand, on deposit, and in transit through observation and confirmation. ● Confirm selected transfer positions with transfer agents for securities pending transfer of title, exchange, or redemption.
<ul style="list-style-type: none"> ● Physical/Vault ● Depositories ● Custodians ● In-Transit 		Withdrawals of securities from vault or box locations are authorized and valid.	<ul style="list-style-type: none"> ● Test compliance with controls for the following: <ul style="list-style-type: none"> — Withdrawal of securities from the vault or box for deliveries by authorized personnel, — Segregation of duties between personnel responsible for balancing cash and related securities positions.

	Differences discovered as a result of security counts or verifications are recorded and resolved on a timely basis.	<ul style="list-style-type: none"> ● Test compliance with controls for the following: <ul style="list-style-type: none"> — Balancing the stock record. — Performing box reconciliations between actual positions and recorded positions. — Resolving security count differences. ● Test procedures for recording securities movements between branches, custodians, and transfer agents. ● Test reconciliations of branch box positions with the recorded positions at the home office.
Recording	The movement of securities is properly recorded.	
Securities Record	Positions listed on the securities recorded are complete.	<ul style="list-style-type: none"> ● Test the securities record to ensure it balances. ● Test the arithmetic accuracy of the securities record for select securities.
Commission Revenue	Commission revenue is fairly stated.	<ul style="list-style-type: none"> ● Perform analytical procedures on commission revenue based on independent variables such as the following: <ul style="list-style-type: none"> — Commission rates (full and discounted) — Number of transactions and the average shares per trade. — The retail/institutional mix. — Industry trends. ● Perform detail test of commission amounts for selected trades (test of transactions): <ul style="list-style-type: none"> — Agree to commission per trade ticket to approved commission rate schedule. — Agree to commission from ticket to daily summary. — Agree total per summary to appropriate general ledger account.
	Commission revenue is recorded in the proper period.	<ul style="list-style-type: none"> ● Perform analytical procedures and analyze unusual variations— <ul style="list-style-type: none"> — Quarter-to-quarter — Year-to-year. ● Beginning with source documentation, recalculate the commission revenue on a sample basis and agree the amounts to those recorded in the general ledger.
Cutoff		
Principal Transaction Revenue	Principal transaction revenue earned from firm trading is fairly stated.	<ul style="list-style-type: none"> ● Perform detail test of realized revenue recognized on selected principal transactions: <ul style="list-style-type: none"> — 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 test 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.

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Audit Areas	Audit Assertions	Audit Objectives	Examples of Substantive Tests and Tests of Control
Interest Revenue/Expense	Validity/Completeness	Principal transaction revenue is recorded in the proper period.	<ul style="list-style-type: none"> ● Perform analytical procedures and analyze unusual variances— <ul style="list-style-type: none"> — 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.
Interest Revenue/Expense	Validity/Completeness	Interest revenue/expense on firm positions and customer margin accounts are fairly stated.	<ul style="list-style-type: none"> ● Perform analytical procedures on interest revenue/expense based on the following: <ul style="list-style-type: none"> — Weighted average balances in customer margin, firm inventory, stock borrow/loaned, and repo/resale accounts. — Weighted average balances outstanding in commercial paper, bank loans, affiliated — Average interest rates.
Investment Banking Underwriting Revenue	Validity/Completeness	Interest revenue and expenses are recorded in the proper period.	<ul style="list-style-type: none"> ● Perform analytical procedures and analyze unusual variances— <ul style="list-style-type: none"> — Quarter-to-quarter — Year-to-year ● For interest revenue, beginning with source documentation, recalculate interest revenue on a sample basis and agree the amounts to the general ledger. ● For interest expense, beginning with the general ledger balances, agree the amounts to source documentation and recalculations.
Investment Banking Underwriting Revenue	Validity/Completeness	Revenues, expenses, and good-faith deposits from underwriting deals are fairly stated.	<ul style="list-style-type: none"> ● Perform analytical procedures on investment banking revenue as it relates to the following: <ul style="list-style-type: none"> — Number and average size of initial public offering (IPO) transactions. — The equity/fixed-income underwriting mix. — Industry trends for underwriting fee percentages. ● Perform detail test of selected deals, as follows: <ul style="list-style-type: none"> — Obtain client files for selected deals. — Agree all pertinent details from prospectus to client files (that is, amount of issue, fees per unit). — Recalculate underwriting fees for the selected deals based on independent documentation. — Agree to appropriate general ledger account and investigate material variance.
Investment Banking Underwriting Revenue	Valuation	Final accounting for managed underwriting deals, including the allocations of expenses, are completed on a timely basis. Reserves are properly established to adequately reflect exposure.	<ul style="list-style-type: none"> ● Test procedures for performing final accountings on underwriting deals (that is, expense allocations and timeliness). ● Determine whether reserves are adequate relative to exposure (that is, litigation contingencies).

Compensation Expense	<p>Presentation Investment banking revenue and expenses are properly classified in the financial statements.</p> <p>Cutoff Investment banking revenue is accurately recorded in the proper period.</p> <p>Validity/Completeness Compensation expense is fairly stated.</p>	<ul style="list-style-type: none"> ● Determine the appropriateness of financial statement presentation and related disclosures. ● Recalculate the recorded revenue amounts and determine whether the amounts were recorded in the proper period. ● Perform analytical procedures on compensation amounts for salaries and commission employees based on the following: <ul style="list-style-type: none"> — Number of employees. — Average salary increases. — Total commission revenue versus commission payouts. — Additional incentive compensation plans. ● Perform mini-max test of compensation expense based in independent records maintained by the personnel department. ● Test incentive compensation schedule and reconcile payroll amounts to the general ledger and financial statements.
Presentation	<p>Compensation expense is properly disclosed in the financial statements.</p>	<ul style="list-style-type: none"> ● Determine the appropriateness of financial statement presentation and related disclosures. <ul style="list-style-type: none"> — Pension-related amounts are properly disclosed. — Applicable amounts are confirmed with an actuary.
Cutoff	<p>Compensation expenses incurred are recorded in the proper period.</p>	<ul style="list-style-type: none"> ● Test subsequent payroll checks to employees on a sample basis to ensure that the compensations expense related to the payment was recorded in the proper period.
Validity/Completeness	<p>Other expenses are fairly stated.</p>	<ul style="list-style-type: none"> ● Perform analytical procedures on expense amounts based on relevant variables and relationships. ● Perform test of transactions on selected expense items; agree supporting documentation to recorded amounts. ● Recalculated depreciation and amortization amounts.
Other Expenses: ● Brokerage and Clearing ● Depreciation ● Occupancy ● Communications ● Professional Fees ● Advertising ● Supplies	<p>All other expenses incurred are recorded in the proper period.</p> <p>Tax expense is fairly stated.</p>	<ul style="list-style-type: none"> ● Test subsequent payments to determine that expenses paid are recorded in the proper period. ● Tax personnel scan the reconciliation of book income to taxable income. ● Determine whether documentation supports permanent and temporary tax differences.
Taxes	<p>Tax expense is fairly stated.</p>	<ul style="list-style-type: none"> ● Tax personnel scan the reconciliation of book income to taxable income. ● Determine whether documentation supports permanent and temporary tax differences.

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Audit Areas	Audit Assertions	Audit Objectives	Examples of Substantive Tests and Tests of Control
Regulatory	Rule 15c3-1	Net capital is properly computed and minimum requirements met, in accordance with SEC rule 15c3-1.	<p data-bbox="205 303 229 720"><i>Examples of Substantive Tests and Tests of Control</i></p> <ul style="list-style-type: none"> ● Test procedures for compliance with the net capital requirements of SEC rule 15c3-1. ● Perform analytical procedures on the net capital computation, including the following: <ul style="list-style-type: none"> — Nonallowable assets. — Subordinated debt added. — Haircuts and capital charges deducted. ● Test nonallowable (illiquid) assets deducted in the net capital computation as follows: <ul style="list-style-type: none"> — Other broker-dealer receivables. — Loans to affiliates. — Property, plant, and equipment. — Other nonallowable assets. ● Test procedures for determining and reporting the following items: <ul style="list-style-type: none"> — Net debit cash reconciling items aged over 7 business days. — Dividend and interest-related aged items. — Fail-to-receive/deliver, securities loaned/borrowed, and repo/resale items. — Suspense-related aged items. — Unsecured and partly secured amounts in margin customer accounts. ● Determine that allowable receivables from other broker-dealers are covered by PAIB agreements. ● Test the procedures for compliance with capital charges related to buy-in provisions for foreign securities. ● Read agreements from the examining authority, for example, the New York Stock Exchange supporting selected subordinated liabilities treated as <i>good capital</i> for the net capital computation. ● Confirm subordination agreements. ● Determine for fixed assets collateralizing intercompany loans that the net book value, is sufficient to meet regulatory requirements. <p data-bbox="829 1223 852 1449">Net capital is properly reduced for haircuts on firm inventory positions.</p> <ul style="list-style-type: none"> ● Test selected haircuts deducted in the net capital computation, as follows: <ul style="list-style-type: none"> — Determine that classifications are proper based on type of securities and maturity for fixed-income products. — Determine that securities with a limited market, unregistered securities, and securities with <i>below-investment-grade</i> ratings are properly reported and receive the proper haircut. — Recalculate haircuts using percentages found in rule 15c3-1, including reductions for hedges ● Read the Financial and Operational Combined Uniform Single (FOCUS) report and agree totals from the general ledger to supporting schedules and totals from such schedules to the FOCUS report.

Rule 15c3-3

Possession and control (P&C) requirements are met in accordance with SEC rule 15c3-3.

- Test compliance with procedures for obtaining and maintaining possession or control of all fully paid and excess-margin securities of customers:
 - For tests and coding of accounts on the company's segregation system, (1) determine that accounts coded as good control satisfy the requirements of SEC rule 15c3-3, (2) determine that other short positions are properly coded (for example, stock loan, fails to receive, bank loan, etc.), (3) verify that the customer margin and cash accounts are appropriately classified (select accounts), (4) determine that other accounts that are required to be segregated are appropriately coded (for example, suspense, difference, unclaimed dividends should be treated as fully paid by the customer).
 - Recompute the value of securities required to be segregated for select accounts and verify that instructions were issued.
 - Recompile the allocation of securities for determining whether the appropriate quantity of securities are segregated.
 - Test the pricing of securities.
- Test procedures for recording due bill repos and compliance with possession or control requirements.
- Test procedures to prevent the creation or increase of a segregation deficit. Select individual deliveries to verify that deficits are not created or increased.
- Test procedures for buying-in fails-to-receive and aged stock dividend receivables and recalls of securities loaned.
- Test procedures for identifying and buying-in customer cash shorts (sales not long) aged over 10 business days from the settlement date.
- Perform analytical procedures on the reserve formula computation.
- Test computation for determination of reserve requirements.
- Test that cash or qualified securities are deposited as required on a timely basis.
- Recompute the allocation of fails, securities loaned/borrowed, bank loans, firm inventory and customer shorts, repos and resales for select securities.
- Determine that documentation demonstrates that the special reserve bank account is for / the exclusive benefit of customers.
- Test the procedures and compliance for buying-in aged security count differences and certain foreign securities (or alternative capital treatment)

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Segregated cash is sufficient to meet the requirements of the reserve formula computation in accordance with SEC rule 15c#-3.

Audit Areas	Audit Assertions	Audit Objectives	Examples of Substantive Tests and Tests of Control
Off-Balance-Sheet Items	Complete Validity	Requirements of Regulation T and NYSE rule 431 are being complied with for all customer cash and margin accounts.	<ul style="list-style-type: none"> ● Test initial and maintenance margin requirements under "house rules" for various products to determine compliance with Regulation T and NYSE rule 431. ● Test the pricing of securities used in the margining of customer accounts. ● Test selected customer margin accounts to determine that a minimum amount of equity is maintained in the account. ● Test selected transactions recorded in customer cash accounts to determine that funds/securities (for purchase/sales) have been received within seven days of trade date. ● Test procedures for determining and issuing maintenance calls for funds collections. ● Test selected calls to determine that funds/securities have been received within five business days from the date of issue. ● Test procedures for filing extensions with the regulatory agencies if maintenance calls are not paid on a timely basis. ● Test procedures for filing extensions with the regulatory agencies if maintenance calls are not paid on a timely basis.
	Rule 17a-13	Quarterly examinations, counts, verifications, and comparisons of securities on hand, on deposit, in transit, out of transfer, and pledged as collateral, are performed as required by rule 17a-13.	<ul style="list-style-type: none"> ● Observe and test the quarterly count/comparison of securities on hand, on deposit, in transfer, or in transit.
	Valuation	Fails, securities loaned and borrowed, and securities pledged aged over thirty calendar days and transfer items over forty days are subject to verification through confirmation.	<ul style="list-style-type: none"> ● Test confirmation replies of security positions over thirty calendar days old.
	Valuation	All items with off-balance-sheet risk are valid and properly identified and monitored. Products classified as off-balance-sheet items are entitled to such treatment.	<ul style="list-style-type: none"> ● Test compliance with relevant controls, including the following: <ul style="list-style-type: none"> — Documentation that is maintained for each contract. — Authorization structure for approving off-balance-sheet transactions. — Review procedures in place for periodically monitoring open commitments to determine if all commitments are valid and properly authorized and valued. ● Confirmed terms of each transaction on a sample basis, based on exposure relative to each of the open commitments. ● Test selected signed contracts.
	Valuation	Reserves are properly established to adequately reflect exposure due to credit and market risks	

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Appendix A—Consideration of Fraud in a Financial Statement Audit: Examples and Considerations for Auditors of Brokers and Dealers in Securities

Risk Factors and Auditor Responses (see paragraphs 5.52 and 5.63b of the Guide)

Two types of fraud are relevant to the auditor's consideration: fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: incentives/pressures, opportunities, and attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Part 1: Fraudulent Financial Reporting

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

A. Incentives/Pressures

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
 - a. High degree of competition or market saturation, accompanied by declining margins.
 - (1) High-degree of competition relating to bank-owned broker-dealers that have been granted expanded powers to engage in securities activities or registered investment companies/mutual funds, accompanied by declining margins.
 - b. High vulnerability to rapid changes, such as changes in technology, or interest rates.
 - (1) A failure or inability to keep pace with the rapid growth in electronic trading, if the financial stability or profitability of the particular entity is placed at risk, due to that failure or inability.
 - (2) Concentration in a particular type of financial instrument.
 - c. Unusually high level of "soft dollar" brokerage activities.
2. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- (2) Lack of sufficient access controls for front-office and back-office systems.
 - (3) Lack of adequate "Chinese Wall" between investment banking and trading (that is, potential for insider trading).
 - (4) Failure to monitor the filling of customer orders from the firm's inventory (for example, front-running and excessive mark-up).
 - (5) Lack of review of customer lists and insufficient controls surrounding the customer account approval and maintenance processes for both cash and margin accounts.
 - (6) A lack of sufficient controls over the review process for new products, structured finance, and off-balance-sheet transactions.
 - (7) A lack of sufficient controls over the valuation process for less liquid securities, including controls over the changes of valuation pricing and the appropriate segregation of duties.
- b.* High turnover rates or employment of ineffective accounting, internal audit, or information technology staff.
- (1) A failure by management to ensure that the brokers are properly trained, appropriately licensed, and adequately supervised.
 - (2) Lack of policies and training over the range of product offerings.
 - (3) A failure by management to assess the quality and breadth of the company's internal audit department, to ensure that the department receives adequate training and resources to match the sophistication and progression of the company.
 - (4) Improper reporting lines for internal audit.
- c.* Ineffective accounting and information systems, including situations involving control deficiencies and material weaknesses.
- (1) Lack of board approval and a specialist's independent evaluation of in-house developed valuation models.
- d.* Use of error accounts to hide trading errors, made to meet commitments to clients, particularly for block trades in meeting a predetermined value-weighted average price (VWAP).
- e.* Use of valuation reserves for other purposes, such as to hide errors or expenses. Assumptions in valuation reserves may be changed without adequate approval. Lack of proper approval for the establishment of valuation reserves.
- f.* Use of customer collateral for firm purposes. (Tested by possession or control procedures.)

Brokers and Dealers in Securities

- g.* Intercompany transactions designed to improperly manage earnings.
- h.* Transactions accounted for as sales as opposed to financing.
- i.* Use of different valuations of same product in two related companies.
- j.* Use of a borrowed security to cover a theft of customer-related security.
- k.* Poor controls over corporate actions in which the client fails to receive entire benefit.
- l.* Not properly valuing collateral or reflecting the extent of cross-collateralization on rate swaps.
- m.* Weak controls causing a failure to record trades on a timely basis, which may facilitate customers' poor trading activity.
- n.* Lack of controls over the execution of customer transactions.

C. Attitudes/Rationalizations

Risk factors reflective of attitudes/rationalizations by board members, management, or employees that allow them to engage in and/or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

1. Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
 - a.* Unusually aggressive interpretations of regulatory rules (for example, net capital rules and weekly reserve formula) when the company is reaching minimum net capital required by the Securities and Exchange Commission (SEC).
 - b.* Lax attitude toward regulatory compliance (example: security segregation requirements).

D. Auditor Responses

In addition to the sample responses presented in AU section 316, an auditor may want to consider the following responses.

- Extend confirmation procedures concerning agreements with counterparties (for example, leases, clearing, custody, margin, and subordinated debt).
- Extend confirmation procedures concerning the terms of selected transactions (for example, swaps, financing transactions, and fails) with counterparties.
- Review the results of valuation testing performed by departments of the company (for example, controllers, internal audit, and middle office).
- Review background information about the board of directors and management to determine if they have the capacity to understand trading and investment strategies. Conversations with appropriate people and

review of the board's and management's experience and credentials may be necessary.

- Review management summary reports on performance and meet with management to discuss trading and business direction.
- Perform periodic reviews of valuation methodologies by independent specialists throughout the year.
- Meet with middle office personnel to gain an understanding of the company's policies concerning managing risk (for example, stress testing and valuations).
- Extend testing on regulatory computations for companies barely meeting the minimum net capital requirements.
- Extend testing of the entity's "soft dollar" arrangements to ensure compliance with the SEC rules and regulations.
- How management dealt with regulatory issues in the past.
- How management responded to past regulatory examinations.
- Is there a code of conduct.

Part 2: Misappropriation of Assets

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

Risk factors that relate to misstatements arising from misappropriation of assets are also classified along the three conditions generally present when fraud exists: incentives/pressures, opportunity, and attitudes/rationalizations. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and weakness in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exists. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

A. Opportunities

1. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:
 - a. Securities (for example, bearer instruments) held in the company's vault.
 - b. Commingling of customer securities with the entity's securities at a custodian bank.
2. Inadequate internal control over assets may increase the susceptibility to misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
 - a. Inadequate management oversight of employees responsible for assets.

Brokers and Dealers in Securities

- (1) Lack of management oversight of extensive retail branches, or overseas branches and subsidiaries.
 - (2) Inadequate supervision of traders' trading practices and limits, especially for those generating a large proportion of the entity's total revenue.
 - (3) Large amounts of cash or securities at branches or branch offices.
 - (4) Poor control over wire transfers.
- b. Inadequate segregation of duties or independent checks.*
- (1) Lack of segregation of duties between the front-office (that is, execution of trades) and the back-office (that is, settlement and accounting for trades).
 - (2) Lack of independent review of periodic reconciliations (for example, settlement accounts, cash accounts, and stock records).
 - (3) Failure to confirm failed transactions on a timely basis.
 - (4) Failure to periodically review items in suspense accounts.
 - (5) Failure to review the aging of items, including failed transactions and receivables.
 - (6) Lack of or infrequent independent pricing of inventory performed by middle-office or back-office (that is, risk management and controller's group).
 - (7) Poor controls over journal entries to customer accounts.
 - (8) Failure to confirm customer transactions on a timely basis.
- c. Inadequate physical safeguards over cash, investments, inventory, or fixed assets.*
- (1) Lack of safeguarding and insuring securities in transfer.
 - (2) Lack of sufficient access controls for cash wiring systems.
- d. Lack of timely and appropriate documentation of transactions.*
- (1) Lack of documentation related to "soft dollar" brokerage activities.
 - (2) Lack of documentation related to derivative transactions with counter parties, such as ISDA master agreements.
- e. Lack of controls relating to the rehypothecation of securities.*

B. Auditor Responses

In addition to the sample responses presented in AU section 316, an auditor may want to consider the following responses.

- Review exception and break reports for settlement activities.
- Ensure that the compliance function reviews the personal account statements of the company's employees.
- Extend testing of access controls of online fund wiring system terminals.
- Review revenue trend of an individual trader over a period of time.
- Review level of errors and broker chargebacks of commissions.
- Look at controls over dealing with customer complaints.

Unusual or Unexpected Relationships (see paragraph 5.54 of the Guide)

Examples of unusual or unexpected relationships that may indicate a material misstatement due to fraud may include the following:

- Recognition of unusually high unrealized gains on financial instruments at financial statement date.
- High volume of transactions around financial statement date.

Accounts, Classes of Transactions, and Assertions (see paragraph 5.57 of the Guide)

Examples of accounts, classes of transactions and assertions that may have high inherent risk, involve a high degree of management judgment and subjectivity and be susceptible to manipulation by management:

- Valuation of inventory.
- Litigation reserves.
- Intercompany transactions.
- Valuation of collateral.
- Bonus determinations.
- Use of special-purpose entities.

Improper Revenue Recognition (see paragraph 5.58 of the Guide)

Examples of improper revenue recognition may include:

- Incorrect valuation of inventory.
- Transactions between related entities designed to improperly manage earnings.
- Accelerating or deferring revenue to other periods.

Key Estimates (see paragraph 5.60 of the Guide)

Examples of key estimates for brokers and dealers in securities may include:

- Valuation of inventory.
- Litigation reserves.

- Bonus determinations.
- Determination of carrying amount of goodwill.
- Reliaization of deferred tax assets.

Programs and Controls (see paragraph 5.61 of the Guide)

Examples of programs and controls for brokers and dealers in securities may include:

- Code of conduct.
- Risk monitoring procedures for credit risk and market risk.

Chapter 6

Internal Control*

Auditor's Consideration of Internal Control in a Financial Statement Audit

6.01 The regulatory environment has a major effect on the audit of a broker-dealer because of the requirements that the auditor report on the adequacy of the broker-dealer's internal control in accordance with SEC Rule 17a-5(g)(1) and on its compliance with specific rules addressing financial responsibility and recordkeeping. Auditors of issuers are also required to audit and report on management's assessment of the company's internal control over financial reporting in conjunction with their audit of the company's financial statements. AU section 320 of PCAOB Standards, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*), establishes requirements and provides directions that apply when an auditor is engaged to audit both a company's financial statements and management's assessment of the effectiveness of internal control over financial reporting. For purposes of evaluating the effectiveness of internal control over financial reporting in accordance with PCAOB standards, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit. (*Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2*, AU sec. 319.42) Moreover, the auditor may be required to test the design and operating effectiveness of some controls he or she might not test if expressing an opinion only on the financial statements. (AU sec. 320.148 [AICPA, *PCAOB Standards and Related Rules*]) The understanding of internal control over financial reporting the auditor obtains and the procedures the auditor performs for purposes of expressing an opinion on management's assessment are interrelated with the internal control understanding the auditor obtains and procedures the auditor performs to assess control risk for purposes of expressing an opinion on the financial statements. As a result, it is efficient for the auditor to coordinate obtaining the understanding and performing the procedures. (AU sec. 320.146 [AICPA, *PCAOB Standards and Related Rules*])

6.02 This part of the chapter discusses the auditor's consideration of internal control in auditing a broker-dealer's financial statements. The "Broker-Dealer Control and Monitoring Activities" part of the chapter provides an

* Refer to the Preface of this Guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the Preface). The Preface also discusses the Sarbanes-Oxley Act requirement that *all* broker-dealers (both public and private) be audited by a public accounting firm registered with the PCAOB and the SEC deferral of that requirement.

In March 2006, the ASB issued eight SASs (SAS No. 104 through SAS No. 111) related to risk assessment. It is anticipated that to implement the SASs appropriately, many firms will have to make significant revisions to their audit methodologies and train their personnel accordingly. The SASs are effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. Refer to the Preface of this Guide for more information. It is anticipated that the May 2007 edition of this Guide will be updated to reflect changes arising from these eight SASs.

As applicable, this chapter contains dual referencing to both the AICPA and the PCAOB professional standards. Refer to the Preface for more information on dual referencing.

overview of the types of control and monitoring activities that are unique to brokers-dealers. This Guide is not intended to provide guidance to auditors on how to comply with the requirements of AU section 320 of PCAOB Standards although it highlights, as appropriate, some of the additional requirements imposed by that standard.¹ The term "audit" generally refers to the audit of financial statements unless it is indicated that the discussion pertains to the integrated audit or audit of internal controls.

6.03 The second standard of fieldwork states that the auditor should obtain a sufficient understanding of internal control to plan the audit of financial statements and to determine the nature, timing, and extent of tests to be performed. AU section 319, *Consideration of Internal Control in a Financial Statement Audit*¹ (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), defines internal control as a process, effected by an entity's board of directors, management, and other personnel, that is designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- a. The reliability of the entity's financial reporting
- b. The effectiveness and efficiency of the entity's operations
- c. The entity's compliance with applicable laws and regulations

6.04 There is a direct relationship between an entity's objectives related to financial reporting, operations, and compliance, which are what an entity strives to achieve, and the components of internal control, which represent what is needed to achieve the objectives. The following are the five interrelated internal control components:

- a. *Control environment* sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure

¹ Auditors of issuers may wish to refer to *The Auditor's Guide to Understanding PCAOB Auditing Standard No. 2*, issued by the AICPA, to help them understand the requirements of PCAOB Auditing Standard No. 2. Subsequent to the approval of the Auditing Standard No. 2, the PCAOB issued staff questions and answers titled, *Auditing Internal Control over Financial Reporting*, which address certain specific practice issues relating to the Auditing Standards No. 2. These documents, which are available at the PCAOB Web site (www.pcaobus.org), set forth the PCAOB staff's opinions and views on certain matters. Pertinent guidance from these documents has also been included in this Guide.

The SEC Staff also issued a set of FAQs regarding Management's Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reports. These FAQs address issues that have arisen since implementing and interpreting the rules that the SEC released for such reports on June 5, 2003 [SEC Release Nos. 33-8238; 34-47986; IC-26068]. These FAQs can be accessed at www.sec.gov/info/accountants/controlfaq1004.htm.

Auditors of issuers may also wish to refer to *A Framework for Evaluating Control Exceptions and Deficiencies* on the evaluation of exceptions and deficiencies resulting from the evaluation of a company's internal control over financial reporting which was developed by representatives of nine CPA firms and a professor at Georgia State University. This paper should be read in conjunction with PCAOB Auditing Standard No. 2. The framework is not a substitute for PCAOB Auditing Standard No. 2 and other relevant professional literature, nor will its mere mechanical application, in and of itself, necessarily lead to an appropriate conclusion. The framework can be obtained at www.aicpa.org/cpaaf/download/Framework%20-%20Version%203.pdf.

[†] For audits of privately held entities or other "non issuers," SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), has been superseded by SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*. SAS No. 109 and No. 110 are effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. Refer to the Preface of this Guide for more information.

- b. *Risk assessment* is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed
- c. *Control activities* are the policies and procedures that help ensure that management directives are carried out
- d. *Information and communication* systems support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities
- e. *Monitoring* is a process that assesses the quality of internal control performance over time.

6.05 Internal control is relevant to the entire entity and to any operating units or business functions. The auditor should obtain an understanding of the broker-dealer's internal control sufficient to plan the audit of financial statements. A sufficient understanding is obtained by performing procedures to understand the design of controls relevant to an audit of financial statements and determining whether they have been placed in operation. In obtaining this understanding, the auditor considers how an entity's use of information technology (IT) and manual procedures may affect controls relevant to the audit of financial statements. IT encompasses automated means of originating, processing, storing, and communicating information, and includes recording devices, communication systems, computer systems, and other electronic devices. The auditor is primarily interested in the entity's use of IT to initiate, record, process, and report transactions or other financial data.

6.06 The auditor then assesses control risk for the assertions² embodied in the account balance, transaction class, and disclosure components of the financial statements.

6.07 For audits conducted in accordance with PCAOB standards, regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements. The auditor should refer to paragraphs 68–70 of AU section 320 of PCAOB Standards for a discussion of identifying relevant financial statement assertions. (*Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2*, AU sec. 319.02)

6.08 The auditor may determine that assessing control risk below the maximum level (the maximum level as used in AU section 319^a means the greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by an entity's internal control) for certain assertions would be effective and more efficient than performing only substantive tests. In addition, the auditor may determine that it is not practical or possible to restrict detection risk to an acceptable level by performing only substantive tests for one or more financial statement assertions. In such circumstances, the auditor should obtain evidential matter about the effectiveness of both the design and operation

² PCAOB guidance provided in AU section 319.02 (AICPA, *PCAOB Standards and Related Rules*) differs from the AICPA guidance in AU section 319.02 (AICPA, *Professional Standards*, vol. 1) as follows: the term "assertions" used in the AICPA *Professional Standards* was replaced with the term "relevant assertions" in the PCAOB Standards.

^a AU section 319 can be found in AICPA *Professional Standards* and PCAOB *Standards and Related Rules*.

of controls to reduce the assessed level of control risk. Such evidential matter may be obtained from tests of controls planned and performed concurrent with or subsequent to obtaining the understanding. If the auditor is unable to obtain such evidential matter, he or she should consider the guidance in AU section 326.14 and .25, *Evidential Matter*[†] (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*). Such evidential matter may also be obtained from procedures that were not specifically planned as tests of controls but that nevertheless provide evidential matter about the effectiveness of the design and operation of the controls. For certain assertions, the auditor may desire to further reduce the assessed level of control risk. In such cases, the auditor considers whether evidential matter sufficient to support a further reduction is likely to be available and whether performing additional tests of controls to obtain such evidential matter would be efficient.

6.09 Alternatively, the auditor may assess control risk at the maximum level because he or she believes controls are unlikely to pertain to an assertion or are unlikely to be effective, or because evaluating the effectiveness of controls would be inefficient. However, the auditor needs to be satisfied that performing only substantive tests would be effective in restricting detection risk to an acceptable level. When evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form, the auditor's ability to obtain the desired assurance only from substantive tests would significantly diminish.

Considerations for Integrated Audits

When performing an integrated audit, if the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion. Accordingly, if control risk is assessed at the maximum level, the auditor should document the basis for that conclusion. Refer to paragraphs 159 through 161 of AU section 320 of PCAOB Standards for additional information regarding documentation requirements. (*Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2*, AU sec. 319.65 and .83)

6.10 After obtaining the understanding and assessing the control risk, the auditor may desire to further reduce the assessed level of control risk for certain assertions. In such cases, the auditor considers whether additional evidential matter sufficient to support a further reduction is likely to be available and whether performing additional tests of controls to obtain such evidential matter would be efficient. The auditor uses the understanding of the broker-dealer's internal control and the assessed level of control risk in determining the nature, timing, and extent of substantive tests for financial statement assertions.

Considering the Control Environment

6.11 The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the following:

[†] For audits of privately held entities or other "non issuers," SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), has been superseded SAS No. 106, *Audit Evidence*. SAS No. 106 is effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. Refer to the Preface of this Guide for more information.

- Integrity and ethical values
- Commitment to competence
- Board of directors or audit committee participation
- Management's philosophy and operating style
- Organizational structure
- Assignment of authority and responsibility
- Human resource policies and practices

6.12 The control environment comprises the conditions under which the broker-dealer's information and communication system, the risk assessment process, monitoring, and control activities are designed, implemented, and function.

6.13 The control environment represents the collective effect of various factors on the overall effectiveness of the broker-dealer's internal control. These factors include the following:

- Management's personal characteristics, philosophy, and operating style and its commitment to accurate financial reporting have a significant influence on the control environment, particularly if management is dominated by one or a few individuals. A positive tone at the top is an important prerequisite to accurate and complete financial reporting. In a broker-dealer, compliance and control over legal matters are important indicators of the overall philosophy held by senior management. Management's approach to taking and monitoring business risks and its commitment to accurate financial reporting are other indications of the tone at the top. Management's commitment to accurate financial reporting may influence the activities of employees throughout the organization. Likewise, the types of activities that a broker-dealer engages in, as well as the amount of risk they are willing to take, affect their operating style. For example, the following business activities may affect management's operating style:
 - Retail brokerage
 - Discount brokerage
 - Arbitrage trading
 - Venture capital
 - Merchant banking
 - Underwriting initial public offerings (IPOs)
- The external business and regulatory environment motivates management to establish and maintain effective internal control in a broker-dealer. For example, examinations by self regulatory bodies and their enforcement powers, as well as review of compliance reports by the Securities and Exchange Commission (SEC) and other governmental bodies, motivate the management of broker-dealers to establish effective controls.
- Management's commitment to designing and maintaining reliable accounting and stock record systems has a significant influence on the control environment. A low level of management concern about acceptable business practices, as well as deficiencies in controls, may lead a broker-dealer's employees either to adopt a similarly low level of concern or to attempt to take advantage of deficient controls. The

reliability of information systems and the effectiveness of controls may be impaired as a result. Personnel policies may enhance or inhibit the competence and continuity of the broker-dealer's employees. An inadequate or incompetent staff that is unable to process transactions and perform control activities may lead to a reduction in the reliability of information systems and the effectiveness of controls. To understand the degree of management's commitment to the design and maintenance of effective internal control and reliable accounting and stock record systems, the auditor should review the guidance contained in AU section 319^a and should consider the following broker-dealer policies:

- Systems security
 - Trading limits
 - Sales practices
 - Hiring practices
 - Risk monitoring
 - Management's response and corrective action taken with respect to material inadequacies in internal control
- Management's ability to control the business also influences the control environment. The board of directors or audit committee should take an active role in overseeing a broker-dealer's accounting and financial reporting practices, as well as those practices regarding the prevention of illegal acts and compliance with laws and regulations. To understand the ability of a broker-dealer's management to control the business, an auditor should consider the following:
 - The broker-dealer's organizational structure
 - The methods used by the broker-dealer in assigning authority and responsibility
 - The ability of the broker-dealer's management to supervise and monitor operations effectively
 - The methods used by senior management to monitor and control the effectiveness of the accounting system and controls

Understanding the Control Environment

6.14 When obtaining an understanding of the control environment, the auditor considers the collective effect on the control environment of strengths and weaknesses in various control environment factors. Management's strengths and weaknesses may have a pervasive effect on internal control. For example, an active and independent board of directors may influence the philosophy and operating style of senior management. Alternatively, management's failure to commit sufficient resources to address security risks presented by IT may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or by allowing unauthorized transactions to be processed. Similarly, human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may not mitigate a strong bias by top management to overstate earnings.

^a See footnote a in paragraph 6.08.

6.15 The auditor should obtain sufficient knowledge of the control environment to understand management's and the board of directors' attitude, awareness, and actions concerning the control environment considering both the substance of controls and their collective effect. The auditor should concentrate on the substance of controls rather than their form because controls may be established but not acted upon. For example, management may establish a formal code of conduct but act in a manner that condones violations of that code.

6.16 In obtaining an understanding of the control environment, the auditor gains knowledge about the overall attitude, awareness, and actions of management and others concerning the importance of control and its emphasis within the broker-dealer. The auditor should also consider management's attitudes, awareness, and actions related to compliance matters that might affect the broker-dealer's financial statements and supplementary schedules. See paragraphs 5.117 through 5.122 for a discussion of the effect of IT on internal control.

Risk Assessment for Financial Reporting Purposes

6.17 A broker-dealer's risk assessment for financial reporting purposes is its identification, analysis, and management of risks relevant to the preparation of financial statements that are fairly presented in conformity with generally accepted accounting principles (GAAP). For example, risk assessment may address how the broker-dealer considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions. Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect a broker-dealer's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Once risks are identified, management considers their significance, the likelihood of their occurrence, and how they should be managed. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

- *Changes in operating environment.* Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- *New personnel.* New personnel may have a different focus on or understanding of internal control.
- *New or revamped information systems.* Significant and rapid changes in information systems can change the risk relating to internal control.
- *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- *New technology.* Incorporating new technologies into operating processes or information systems may change the risk associated with internal control.
- *New business models, products, or activities.* Entering into business areas or transactions with which a broker-dealer has little experience may introduce new risks associated with internal control.

- *Corporate restructurings.* Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- *Expanded foreign operations.* The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- *New accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

6.18 Broker-dealers devote a significant amount of time and resources toward the identification, quantification, analysis, and control of risk. A broker-dealer's control and monitoring activities are concerned with mitigating business risks and exposures. *Risk* refers to the likelihood that a loss might occur, while *exposure* refers to the condition of being unprotected. The decision to incur business risk rests with the broker-dealer's management. The following is an overview of the major risks and exposures facing a broker-dealer.

6.19 *Operational Risk.* Operational risk arises in processing broker-dealer transactions. Exposure can be created by a failure to either process transactions properly or safeguard securities adequately. If operational risk is properly managed, other risks will be mitigated. In viewing operational exposure, it is important to look at the broad exposure within particular accounts, such as suspense accounts, difference accounts, reconciling items (for any accounts), and aged transfers and fails. For instance, within a particular suspense account, the exposure is frequently not the net balance in the account. A more accurate view of exposure is to identify debit-only items (no related security positions), short-market-value-only items (no related money balance), debit money with long market value (LMV), and credit money with short market value (SMV). By viewing each of those items separately, the auditor will better understand the total exposure.

6.20 *Credit Risk.* Credit risk refers to potential losses arising from the failure of another party to perform according to the terms of a contract (counterparty default).

6.21 Credit risk can be customer- or broker-related. The exposure to the broker-dealer is for the amount of extended credit that is not fully collateralized. Therefore, obtaining adequate collateral from the counterparty could help minimize credit risk. An extension of credit can result in any of the following transactions: margin transactions, cash transactions prior to settlement, stock borrows and stock loans, resale and repurchase agreements (repos), swaps, futures, forwards, options, and similar items. Broker-dealers will usually have credit committees, which set limits for total credit lines and exposure and for any particular counterparty.

6.22 *Market Risk.* Market risk refers to potential losses from fluctuations in market prices that may make a financial instrument less valuable or more onerous. A change in market price may occur (for example, for interest-bearing financial instruments) because of changes in general interest rates (interest rate risk), changes in the relationship between general and specific market interest rates (an aspect of credit risk), or changes in the rates of exchange between currencies (foreign exchange risk).

6.23 *Litigation Risk.* Litigation risk refers to the risk of losses resulting from lawsuits and the cost of defending against such claims. Lawsuits can arise from the various aspects of the broker-dealer's business. Areas of particular concern include underwriting activities, as well as the maintenance of customer accounts. Broker-dealers can help mitigate litigation risk in many ways, including the following:

- Establishing policies regarding a code of professional conduct, the employer's responsibilities, and due diligence and establishing a system to monitor compliance with such policies
- Establishing a compliance function to review the activities of the sales departments and branch office operations

6.24 *Regulatory Risk.* Regulatory risk refers to potential losses that might arise for failing to comply with applicable statutes, regulations, and rules. Broker-dealers operate in a highly regulated industry that requires close attention to compliance matters. Not only may such matters affect a broker-dealer's reputation and growth, but noncompliance may also lead to fines, limitation on activities the broker-dealer is allowed to carry out, or even the suspension or revocation of the broker-dealer's registration.

Understanding Risk Assessment

6.25 The auditor should obtain sufficient knowledge of the broker-dealer's risk assessment process to understand how management considers risks relevant to financial reporting objectives and decides about actions to address those risks. This knowledge might include understanding how management identifies risk, estimates the significance of the risks, assesses the likelihood of their occurrence, and relates them to financial reporting. The use of IT may be an important part of a broker-dealer's risk assessment process, including providing timely information to facilitate the identification and management of risks.

6.26 A broker-dealer's risk assessment differs from the auditor's consideration of audit risk in a financial statement audit. The purpose of a broker-dealer's risk assessment is to identify, analyze, and manage risks that affect the broker-dealer's objectives. In a financial statement audit, the auditor assesses inherent and control risks to evaluate the likelihood that material misstatements could occur in the financial statements.

Information and Communication System

6.27 An information system consists of infrastructure (physical and hardware components), software, people, procedures (manual and automated), and data. Infrastructure and software will be absent, or have less significance, in systems that are exclusively or primarily manual. Many information systems make extensive use of IT. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, record, process, and report the broker-dealer's transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. Transactions may be initiated manually or automatically by programmed procedures. Recording includes identifying and capturing the relevant information for transactions or events. Processing includes functions such as edit and validation, calculation, measurement, valuation, summarization,

and reconciliation, whether performed by automated or manual procedures. Reporting relates to the preparation of financial reports as well as other information, in electronic or printed format, that the entity uses in monitoring and other functions. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the broker-dealer's activities and to prepare reliable financial reports. Accordingly, an information system encompasses methods and records that:

- Identify and record all valid transactions.
- Describe, on a timely basis, the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

6.28 Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the broker-dealer. Open communication channels help ensure that exceptions are reported and acted on. Communication can take the form of policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

Understanding the Broker-Dealer's Information and Communication System

6.29 The auditor should obtain sufficient knowledge of the broker-dealer's information system relevant to financial reporting to understand the following:

- The classes of transactions in the broker-dealer's operations that are significant to the financial statements
- The procedures, both automated and manual, by which transactions are initiated, recorded, processed, and reported from their occurrence to their inclusion in the financial statements
- The related accounting records, whether electronic or manual, supporting information, and specific accounts in the financial statements involved in initiating, recording, processing and reporting transactions
- How the information system captures other events and conditions that are significant to the financial statements
- The financial reporting process used to prepare the broker-dealer's financial statements, including significant accounting estimates and disclosures

6.30 When IT is used to initiate, record, process, or report transactions or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for significant accounts or may be critical to the effective functioning of manual controls that depend on IT.

6.31 In obtaining an understanding of the financial reporting process, the auditor should understand the automated and manual procedures an entity uses to prepare financial statements and related disclosures, and how misstatements may occur. Such procedures include:

- The procedures used to enter transaction totals into the general ledger.
- The procedures used to initiate, record, and process journal entries in the general ledger.
- Other procedures used to record recurring and nonrecurring adjustments to the financial statements.

6.32 The auditor also should obtain sufficient knowledge of the means the broker-dealer uses to communicate financial reporting roles and responsibilities and significant matters relating to financial reporting.

Control Activities

6.33 Control activities are the policies and procedures that help ensure that management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the broker-dealer's objectives. Control activities, whether automated or manual, have various objectives and are applied at various organizational and functional levels. Each control activity is designed to accomplish a specific control objective. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:

- Performance reviews (that is, ensuring that controls are performing as expected)
- Information processing
- Physical controls
- Segregation of duties

6.34 Many of the activities of broker-dealers are unique, and consequently, many of the control activities are also unique. Control activities that may address the following audit concerns include the following:

- *Validity.* Control activities designed to reasonably ensure that recorded transactions include only those that have actually occurred.
- *Completeness.* Control activities designed to reasonably ensure that valid transactions are not omitted entirely from the accounting records.
- *Authorization.* Control activities intended to reasonably ensure that transactions are approved before they are executed and recorded.
- *Valuation (accuracy).* Control activities designed to reasonably ensure that dollar amounts and values are correctly determined.
- *Classification.* Control activities intended to reasonably ensure that transactions are recorded in the proper accounts, charged and credited to the appropriate customers, and so on.
- *Presentation and disclosure.* Control activities designed to reasonably ensure that the accounting process for a transaction is completely performed and is in conformity with GAAP.

- *Timing (cutoff)*. Control activities that are designed to reasonably ensure a transaction is accounted for in the proper time period.
- *Regulatory*. Control activities that are designed to reasonably ensure that a transaction complies with the applicable laws and regulations of the SEC and other regulatory bodies.
- *Safeguarding of Assets*. Control activities that are designed to protect against unauthorized acquisition, use or disposal of assets, including customer related assets.

Understanding Control Activities

6.35 The auditor should obtain an understanding of those control activities relevant to planning the audit. As the auditor obtains an understanding of the other components, he or she is also likely to obtain knowledge about some control activities. For example, in obtaining an understanding of the documents, records, and processing steps in the financial reporting information system that pertain to cash, the auditor is likely to become aware of whether bank accounts are reconciled. The auditor should consider the knowledge about the presence or absence of control activities obtained from the understanding of the other components in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities to plan the audit. Ordinarily, audit planning does not require an understanding of the control activities related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to them.

6.36 For purposes of evaluating the effectiveness of internal control over financial reporting in accordance with PCAOB standards, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit. (*Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2*, AU sec. 319.42)

6.37 The auditor should obtain an understanding of how IT affects control activities that are relevant to planning the audit. Some broker-dealers and auditors may view the IT control activities in terms of application controls and general controls. Application controls apply to the processing of individual applications. Accordingly, application controls relate to the use of IT to initiate, record, process, and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed.

6.38 Application controls may be performed by IT or by individuals. When application controls are performed by people interacting with IT, they may be referred to as user controls. The effectiveness of user controls, such as reviews of computer-produced exception reports or other information produced by IT, may depend on the accuracy of the information produced.

6.39 General controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. General controls commonly include controls over data center and network operations; system software acquisition and maintenance; access security; and application system acquisition, development, and maintenance.

6.40 The use of IT affects the way that control activities are implemented. For example, when IT is used in an information system, segregation of duties often is achieved by implementing security controls.

Monitoring

6.41 Monitoring is a process that assesses the quality of an entity's internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions. The frequency with which controls are assessed depends on the significance of the risk being controlled, and the importance of a particular control in reducing the risk. Higher priority risks generally will require more frequent assessment. Similarly, those controls most critical to reducing a given risk will tend to be assessed more often.

6.42 Monitoring can be done through ongoing monitoring activities, through separate evaluations, or a combination of the two. Ongoing monitoring activities are built into the normal recurring activities of a broker-dealer, and include regular management and supervisory activities, comparisons, reconciliations and other actions personnel take in performing their duties. Managers at divisional and corporate levels are in touch with operations and may question reports that differ significantly from their knowledge of operations. Usually, some combination of ongoing monitoring and separate evaluations will together ensure that internal control maintains its effectiveness over time.

6.43 In many broker-dealers, internal auditors or personnel performing similar functions contribute to the monitoring of broker-dealer's activities through separate evaluations. They regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the design and operation of internal control. They communicate information about strengths and weaknesses and recommendations for improving internal control.

6.44 Monitoring activities may include using information from communications from external parties. Customers implicitly corroborate transaction data by paying their amount owed or complaining about their charges. In addition, regulators may communicate with the broker-dealer concerning matters that affect the functioning of internal control, for example, communications concerning examinations by self-regulatory organizations. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

6.45 In many entities, much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors may exist in the information, potentially leading management to incorrect conclusions from its monitoring activities.

Understanding Monitoring Activities

6.46 The auditor should obtain sufficient knowledge of the major types of activities the broker-dealer uses to monitor internal control over financial reporting, including the source of the information related to those activities, and how those activities are used to initiate corrective action. When obtaining an understanding of the internal audit function, the auditor should follow the guidance in paragraphs 4 through 8 of AU section 322, *The Auditor's Consideration*

of the Internal Audit Function in an Audit of Financial Statements (AICPA, Professional Standards, vol. 1; PCAOB Standards and Related Rules).

Broker-Dealer Control and Monitoring Activities

6.47 Control and monitoring activities may be present in the functions of a broker-dealer. Management uses such activities to mitigate business risk. This Guide discusses only those control and monitoring activities that are unique to brokers-dealers. The absence of any of these specific control activities is not indicative of an internal control deficiency; however, an internal control deficiency may exist if the overall control objective is not met.

6.48 The discussion of control and monitoring activities in this part of the chapter is primarily from management's perspective and is intended to provide the auditor with an overview of the types of desirable controls. Management of a broker-dealer has a responsibility to establish and maintain adequate internal control over financial reporting and to comply with specific rules addressing financial responsibility and recordkeeping. Management of an issuer is required by Section 404(a) of the Sarbanes-Oxley Act of 2002 to assess the effectiveness of the company's internal control over financial reporting and to include in the company's annual report to shareholders management's conclusion as a result of that assessment about whether the company's internal control is effective.³ This Guide is not intended to provide guidance to management of issuer broker-dealers on how to comply with the requirements of the Sarbanes-Oxley Act. However, the *SEC Requirements for Management's Report on Internal Control Over Financial Reporting* section at the end of this chapter provides some general information on internal control reporting requirements established by the Sarbanes-Oxley Act.

6.49 Security transactions may be processed, recorded, and monitored by different departments within the broker-dealer. Even though this discussion addresses specific broker-dealer control and monitoring activities, the presentation is general in nature and does not necessarily reflect the actual operations or departments of every broker-dealer. Control and monitoring activities should be performed by persons with appropriate segregation of duties.

Sales and Compliance

6.50 *New Accounts.* Control and monitoring activities for opening and maintaining new accounts are essential for broker-dealers. The opening of new accounts is primarily the responsibility of customer service centers (CSCs) and

³ Management of issuers may wish to refer to *PCAOB Auditing Standard No. 2: A Guide for Financial Managers*, issued by the AICPA, to help them understand the requirements of PCAOB Auditing Standard No. 2. This practice aid focuses on the way in which company management will conduct its own required assessment in internal control effectiveness. Pertinent guidance in the practice aid covers management's responsibilities relating to the company's self-assessment of internal control and the related audit; how the company may and may not work with its auditors to carry out its responsibilities; and the performance requirements for each major phase of the assessment of internal control, including planning the scope of the work, documenting internal control, evaluating the design effectiveness of internal control, testing the operating effectiveness of internal control, and assessing internal control deficiencies.

The SEC Staff also issued a set of FAQs regarding Management's Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reports. These FAQs address issues that have arisen since implementing and interpreting the rules that the SEC released for such reports on June 5, 2003 [SEC Release Nos. 33-8238; 34-47986; IC-26068]. These FAQs can be accessed at www.sec.gov/info/accountants/controlfaq1004.htm.

branch offices. Control and monitoring activities are designed to ensure that recorded transactions are valid, complete, and properly authorized. Broker-dealers follow various activities (some of which are required by regulatory authorities), such as the following:

- Have new accounts approved by appropriate personnel and ensure that the account file contains documentation concerning the essential facts pertaining to each customer. For instance, if the customer is a corporation, the file indicates that the person from whom the orders are accepted is duly authorized by the corporation to act on its behalf. Rules requiring such documentation, as well as related account supervision activities, are referred to as the "know your customer" rules. Special documentation may also be required for other accounts, such as for all customers who wish to trade options or customers who are nonresident aliens.
- Have customer files contain signed copies of IRS Form W-9, "Request for Taxpayer Identification Number and Certification," and, for non-U.S. citizens, IRS Form W-8, "Certificate of Foreign Status."
- Have margin customers sign agreements, referred to as *hypothecation agreements*, that authorize the broker-dealer to use customers' securities that are not fully paid for. Broker-dealers may finance unpaid balances by borrowing money from banks or other broker-dealers, and use customer securities as collateral to the extent permissible.
- Require all accounts in the name of the customer, unless the broker-dealer has received a written statement signed by the customer attesting to his or her ownership of an account in any other name, symbol, or number.
- Mail letters to customers, requesting confirmation after being notified of changes in addresses. Some broker-dealers mail confirmation requests to the customers' last known and current addresses.
- Mail customer statements periodically (at least quarterly, or monthly if there is any activity), unless a customer has requested in writing—and a designated official has approved the request—that the statements not be mailed.
- Require written authorization from each customer for whom the broker-dealer carries a discretionary account, receiving the approval (from a designated person who does not exercise discretionary authority) for every trade in the discretionary account, and mail an advice to the discretionary account customer on the date each trade is executed.
- Identify the accounts of partners, officers, and employees and their known relatives so that transactions in such accounts can be reviewed by designated personnel.
- Obtain written approval from another broker-dealer for opening an account of an employee of that broker-dealer.
- Ensure policies and procedures exist and function to comply with the requirements of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the Patriot Act).

6.51 Order Entry. The primary objectives of the order department are to ensure that all authorized orders are directed to the proper marketplace, executed, and accurately recorded. Control and monitoring activities over customer

orders to purchase and sell securities should be identified and tested because accounting information is generated from customer order forms. Customer orders generate accounting entries that affect the following financial statement accounts:

- Receivables from and payables to customers
- Firm inventory
- Receivables from and payables to other broker-dealers and clearing organizations
- Commission income and expense
- Interest income and expense
- Cash

6.52 Some of the control and monitoring activities typically associated with the order department include—

- Assigning a number to orders when placed and accounting for all order numbers.
- Reviewing, by supervisory personnel, the open order file.
- Comparing trade data recorded on the customer confirmation with the order form prepared by the order department and registered representative before mailing it to the customer.
- Requiring that the execution price of an order be confirmed by the order department to the registered representative, and by the registered representative to the customer, shortly after placing the order. Lack of confirmation of execution usually initiates inquiry by the registered representative or customer.
- Including a check digit in the customer account number on order forms.
- Segregating and not processing orders lacking required information, such as an invalid contra broker-dealer number.
- Verifying completed order forms.
- Not processing limit orders if the execution price is not within predetermined market limits.
- Using order forms that provide for the entry of all relevant information about an order to be processed.
- Time-stamping orders when they are placed, when they are transmitted to exchanges or trading rooms, and upon notice of execution. Disputes regarding prices can be resolved based on the time the order was placed and executed.
- Requiring orders, other than those automatically executed, to be initiated by a registered representative, placed by the order desk, executed by a trader, and confirmed by a floor clerk.
- Reviewing exception reports to resolve quantity and price differences.

6.53 *Sales Compliance.* The compliance department is responsible for ensuring that the broker-dealer's sales activities are conducted in accordance with applicable laws and regulations. Some of the control and monitoring activities typically associated with and in connection with regulatory rules requiring adequate supervision of the sales compliance function include the following:

- Monitoring and reviewing transactions in customer accounts for suitability, particularly with respect to discretionary accounts.
- Documenting and investigating customer complaints.
- Requiring sales representatives to be registered in accordance with applicable regulations.
- Monitoring and reviewing transactions in employee accounts.
- Requiring a cash transaction reporting form to be completed for all receipts of funds, in conformity with the Bank Secrecy Act.
- Reviewing proprietary transactions to identify transactions that may violate prohibitions on insider trading or represent manipulative and deceptive practices.
- Monitoring and actively reviewing closed accounts or inactive accounts.
- Generating and then reviewing exception reports that highlight unusual activity.
- Reviewing sales and advertising literature to ensure compliance with federal and state securities laws, as well as with various regulations of self-regulatory bodies.
- Reviewing IPOs to customers to ensure that the securities offered are registered in accordance with the Securities Act of 1933 and in accordance with state Blue-Sky laws.

Clearance

6.54 *Purchases and Sales.* The purchase and sales (P&S) department processes customer and proprietary orders and is responsible for the following:

- Recording purchases and sales transactions if that is not done automatically through the order entry process
- Preparing confirmations of securities transactions
- Comparing transactions with other broker-dealers and clearing organizations, and computing commissions, taxes, and other fees

6.55 Some of the control and monitoring activities typically associated with the P&S department include the following.

- Compare the total number of orders entered to the total number of orders on the trade date blotter and reconcile any differences (for instance, canceled trades, limit orders not executed, and rejects).
- Recap daily the adjustments between trade date blotters (such as T/D+1, T/D+2, T/D+3) and use them to reconcile those blotters.
- Trace all totals on the settlement blotters to the general ledger.
- Prohibit P&S personnel from obtaining access to customer accounts, stock records, margin records, the cashier's department, and the mailing department.
- Compare order tickets, on a test basis, to entries on the trade date blotter, and recomputing commissions, taxes, and other fees.
- Compare all transactions cleared through clearing organizations with clearing organization contract sheets, or electronically through IT interfaces (including electronic communications networks (ECNs)), and

comparing all broker-to-broker transactions with confirmations received from the contra broker-dealer.

- Balance principal transactions with customers internally against the firm trading accounts with exceptions promptly entered into the suspense file and investigated.
- Balance presettlement customer and streetside transactions daily, to ensure that balance entries are posted to the general ledger and securities record.
- Periodically (preferably daily) review, age, and report to appropriate officials concerning open P&S suspense items because suspended trades represent potential fails, don't knows (DKs), unknown inventory positions, or financing costs.
- Agree amounts and account distributions on the settlement blotter to general ledger entries.
- Summarize on exception reports and actively review "as of" transactions and "canceled and corrected" transactions.
- Mail trade confirmations to customers generally before settlement date and reporting any misstatements noted by customers.

Securities Settlement

6.56 *Receive and Deliver.* All receipts and deliveries of securities and money are handled by the receive-and-deliver section of the cashier's department. Some of the control and monitoring activities typically associated with the receive-and-deliver function include the following:

- Receiving or delivering securities only if they are supported by written instructions prepared by another department or workstation
- Electronic imaging of securities received and delivered to resolve any differences between broker-dealers
- Examining for negotiability (that is, properly endorsed, signed, and guaranteed) and for completeness (that is, coupons and warrants) securities received before they are placed in the active box or vault
- Recording the certificate numbers of securities received
- Authorizing certain designated employees to execute or guarantee assignments
- Maintaining control over the facsimile signature devices used
- Designating an employee who does not handle securities or cash to determine that payment is received when securities are delivered against payment
- Bonding all employees who handle securities
- Balancing daily movements of securities, and assigning responsibility for the clearance of out-of-balance positions to specific individuals who have no other duties related to any other aspects of securities processing
- Investigating and resolving securities positions (and related ledger amounts) in suspense accounts on a timely basis
- Ensuring that due bills for dividends are identified and recorded with the receipt or delivery of securities

- Periodically comparing the details of fails-to-receive and fails-to-deliver with the stock record in accordance with SEC Rule 17a-13, and agreeing the respective amounts receivable or payable to the related general ledger control accounts
- Maintaining aging schedules of fail-to-receive and fail-to-deliver transactions currently, following up on aged fail transactions, initiating buy-ins in accordance with various regulatory rules, and analyzing aged fails for regulatory purposes
- Periodically reviewing operations suspense items to determine the propriety of receivables or payables carried in the account
- Comparing suspense items with underlying trade tickets or other records, and reviewing the propriety of the subsequent clearance of suspense items

6.57 *Extension of Credit.* The margin department, also called the credit department, monitors the extension of credit to customers. Some of the control and monitoring activities over transactions with customers that are typically associated with the margin department include the following:

- Establishing procedures to ensure compliance with the requirements of Federal Reserve Regulation T (Regulation T) including cash, margin, and other accounts, as well as maintenance margin (rule 431) requirements^{ll}
- Implementing a system designed to prevent violations of Regulation T and similar regulations addressing the extension and maintenance of credit, including the prompt issuance of Regulation T calls and maintenance calls, and prompt follow-up action in the event that calls are not met
- Implementing a system to have "house" margin requirements that are higher than those established by regulatory authorities, if it is considered necessary for the protection of the broker-dealer
- Performing credit investigations before transacting business with a customer and before establishing credit limits
- Obtaining signed margin agreements before trading in a margin account can occur
- Disbursing cash and delivering securities only upon written authorization of the appropriate personnel
- Requiring the authorization of margin department personnel before paying funds or withdrawing securities from customers' accounts
- Prohibiting margin clerks from initiating entries to customer accounts and from having contact with customers' securities, remittances, or disbursements
- Assigning responsibility for monitoring customer accounts to specific employees, who are rotated onto other duties periodically
- Reviewing margin records periodically (by an employee who has no duties in connection with them) to determine that the minimum margin requirements of the firm are being maintained

^{ll} Please refer to the footnote to paragraph 3.70 for a discussion of the amended margin rule.

- Promptly reporting to management on customers' undermargined accounts and unsecured or partly secured accounts, for purposes of evaluation as to collectibility
- Delegating duties appropriately and rotating the duties of personnel in key control areas
- Accepting securities received from customers that are registered in a name other than the customer's only if proof of ownership is provided
- Permitting only designated employees to make entries to customer accounts, and requiring that two employees approve changes to customer account files. Limit the types of transactions (such as cash receipts, cash disbursements, securities receipts and deliveries, or adjustments) that an employee can initiate
- Establishing procedures to ensure compliance with the requirements of SEC Rules 400 through 406 and CFTC rules 41.42 through 41.49 governing customer margin for transactions in security futures
- Reviewing securities underlying receivables and payables regularly as to their valuation

Custody

6.58 *Cashiering.* The cashiering department is responsible for the custody, safekeeping, and segregation of securities. Some of the control and monitoring activities typically associated with the custody function include—

- Maintaining securities that are on the premises in a fireproof vault.
- Keeping securities that are not needed in daily operations at depositories.
- Maintaining physical controls over securities on hand by restricting access to areas containing securities to authorized employees, and by keeping the cage and vault doors always locked.
- Using dual controls over access to securities.
- Limiting the number of employees who have access to physical securities.
- Noting, in the records of the broker-dealer, customers' fully paid and excess-margin securities as securities required to be in its physical possession or control in accordance with SEC Rule 15c3-3; maintaining records of customers' fully paid and excess-margin securities not in the broker-dealer's possession or control, determining the location of such securities, and initiating action to bring them into possession or control within the time frame set forth in the rule.
- Periodically imaging electronically securities on hand for use in re-searching any misstatements.
- Conducting surprise counts of securities on hand.
- Confirming securities, counting securities, or both, once each calendar quarter and comparing the results to the books and records, as required under SEC Rule 17a-13, "Quarterly Securities Examinations." SEC Rule 17a-13 requires that certain broker-dealers, at least once in each calendar quarter, physically examine and count all securities held and account for all other securities that are subject to the broker-dealer's control or direction and are not in its physical possession. The counting and verification of securities is required to be performed by

or supervised by personnel that do not have daily responsibility for the securities.

- Agreeing results of security counts, and verifications to the stock record, with any differences noted in accordance with the Rule 17a-13 and followed to a conclusion.
- Agreeing daily, and reconciling at least monthly, the details of transactions for accounts carried by other broker-dealers (such as omnibus accounts), and resolving any differences.
- Daily reconciling of the securities held at depositories to the stock record.
- Balancing, on a daily basis, customer accounts with the stock record and general ledger control accounts, as well as with margin department records.
- Identifying and segregating worthless and restricted securities.

6.59 *Securities Transfer.* The transfer department is responsible for the transfer of ownership and the registration and reissuance of securities. The following are some of the control and monitoring activities typically associated with the transfer department:

- Recording in a memo field on the stock record transfer instructions
- Matching securities received back from the transfer agent against open transfer instructions
- Maintaining and reporting, for management and regulatory purposes, the aging of open transfer items
- Periodically confirming, with the transfer agent, aged open transfer items

Dividends, Interest, and Reorganization

6.60 *Dividends and Interest.* The dividend department normally monitors dividends declared by corporations, monitors the collection (and payment, if the broker-dealer is short) of dividends, records interest and dividends on securities owned by the firm or its customers, and credits customer and firm accounts with their dividends and interest. The following are some of the control and monitoring activities typically associated with the processing of dividends and interest:

- Receiving information regarding dividend declarations electronically from independent dividend-reporting services
- Manually reviewing input dividend information separately
- Obtaining information regarding bond interest coupon dates when new issues are recorded on the securities master file
- Automatically creating, on the record date from an extract of the stock record (commonly referred to as a *take-off sheet*), a dividend file that identifies all long and short security positions in each issue for which a dividend has been declared
- Debiting, through an automated process on the payment date, all entries to customer, noncustomer, and processing accounts
- Recording in the suspense account and having the dividend department investigate differences between money received and the receivable amount or between money paid and the payable amount

- Following up with paying agents or depositories holding the firm's and its customers' securities in street name for payments
- Routinely aging receivables and payables and long and short stock dividends for exposure and for regulatory purposes, and reporting them to management

6.61 Reorganizations. The reorganization department is responsible for the processing of securities involving corporate reorganizations, consolidations, subscriptions, and exchanges. Some of the control and monitoring activities typically associated with reorganization departments include—

- Receiving information regarding pending reorganization transactions electronically from independent reporting services.
- Manually reviewing input reorganization information separately.
- Controlling physical movements of securities subject to pending reorganizations by processing them through the appropriate reorganization accounts.
- Balancing all reorganization transactions on a security-by-security basis.
- Periodically recording and confirming money receivable or securities at agents with any differences entered into a suspense account and investigated.

Mortgage-Backed Securities

6.62 Broker-dealers obtain and sell mortgage-backed securities. Some of the control and monitoring activities that are typically associated with such securities include:

- Establishing and monitoring a standardized strategy for allocating to be announced securities (TBAs) to specified pools.
- Analyzing and monitoring securities received in incoming pools.
- Properly recording unallocated TBAs as fails.
- Ensuring that the allocation of TBAs to pools is efficient, adequately validated, and properly recorded.
- Ensuring that complete and correct factor updates are received on a timely basis.
- Obtaining principal and interest (P&I) information (including factors) from external sources (especially for derivatives) and ensuring that the validated information is updated on the appropriate systems on a timely basis.

Principal Transactions

6.63 Firm Trading. Many broker-dealers buy and sell securities and OTC derivatives in their capacity as dealers and as part of various positioning strategies that attempt to generate profits by anticipating future market movements. These dealer and positioning strategies are collectively referred to as *firm trading*. Given the volatility of the financial markets, proper control and monitoring activities over firm trading activities are critical. Some of the control and

monitoring activities that are typically associated with firm trading generally include—

- Establishing overall position limits, as well as separate limits for each trader and product.
- Monitoring positions daily and daily monitoring trading gains and losses by each trader on a trade date basis.
- Daily reconciling trading desk records, which are maintained on a trade date basis, to the accounting department records.
- Daily marking to market firm trading positions with prices obtained from independent pricing sources.
- Reviewing all trader-determined valuations or overridden valuations.
- Management review of reports of all aged positions.
- Management review of reports of position concentrations.
- Sending trade confirmations to each counterparty.
- Recording traders' phone conversations with counterparties.
- Reviewing daily the automated comparison of settled positions on the firm inventory system versus positions on the stock record.
- Comparing trade tickets to the daily transaction information recorded on the firm's books and records.
- Time-stamping or electronic monitoring of trade tickets at the time a transaction is received and executed.
- Reviewing and verifying all confirmations received from counterparties.
- Daily balancing principal transactions conducted with the broker-dealer's customers.
- Reviewing pending trades file.
- Performing reconciliations between the front-end trading systems and the general ledger.

6.64 Underwriting. A broker-dealer may act as a manager, comanager, or syndicate member in the underwriting of public or private offerings of securities. Many of the control and monitoring activities related to firm trading also serve as control and monitoring activities over underwriting activity. Some additional control and monitoring activities typically associated with the underwriting function include—

- Maintaining the subscription records for the underwriting, and receiving from members of the buying and selling groups reports of orders from their customers, so that the managing underwriter knows at all times the status of the offering.
- Separately accounting for the revenue and expenses of the syndicate.
- Aging, and separately maintaining on a deal-by-deal basis, amounts receivable or payable that are recorded on the broker-dealer's books pursuant to an underwriting.

OTC Derivative Transactions

6.65 Many broker-dealers enter into derivative transactions in their capacity as dealers and as part of various strategies. Some of the control and

monitoring activities that are typically associated with such transactions include—

- Providing training to staff with respect to systems used to process derivatives, as well as technical updates on the processing of and accounting for new products.
- Hiring staff that is experienced with the various types of products processed and ensuring that such staff is supervised by experienced individuals.
- Reviewing the systems used to process and account for derivative transactions in order to ensure that they are operating as intended.
- Ensuring that the system selected to process derivative transactions is able to handle the current and projected volume of business.
- Ensuring that systems or technical personnel are capable of supporting the current system and augmenting features of the system as needed.
- Developing a contingency plan in the event that the system breaks down.
- Restricting access to the system by using codes and passwords.
- Maintaining signed contracts for each derivative transaction, as well as a list of outstanding unsigned contracts.
- Reviewing master netting agreements and presentation of netted transactions to ensure that it complies with requirements of FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts—an interpretation of APB Opinion No. 10 and FASB Statement No. 105*.
- Keeping files of correspondence from counterparties regarding payment instructions, amounts to be paid or received, modifications to current contracts, and notifications of early terminations and final payments.
- Separating the functions of inputting derivative transactions into the system and of verifying the accuracy of the input.
- Separating such functions as monitoring, calculating, and processing of payments and receipts.
- Ensuring that the execution of derivative transactions and the monitoring of counterparty credit quality and counterparty exposure limits are performed by separate individuals.
- Establishing and maintaining formal policies concerning hedging strategies.⁴
- Restricting control and maintenance over legal documentation.
- Performing reconciliations between cash disbursements and receipts, systems calculations, and correspondence from counterparties.
- Performing the valuation of the derivatives portfolio frequently and obtaining, from reliable sources consistently on each valuation date, the market data used to value the portfolio. Limiting access to models used to value positions and reviewing changes made to those models. The valuation process and the verification of this process is performed by separate individuals.

⁴ Hedge accounting is permitted only if the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, are met.

- Analyzing the changes in the portfolio's valuation into the following separate components:
 - Market fluctuations
 - Accretion
 - Swap payments/receipts
 - Maturations/terminations
 - New transactions
- Reconciling traders' estimates of profit and loss to the portfolio valuation system.

Collateralized Financings

6.66 *Stock Loan and Stock Borrow.* These transactions generally result from the need for one broker-dealer to borrow securities for delivery to another broker-dealer or to a customer. At large broker-dealers, the stock loan department has responsibility for entering into such transactions. Some of the control and monitoring activities typically associated with stock loan and stock borrow activity include—

- Reviewing counterparties for creditworthiness and obtaining master trade agreements and credit approval for counterparties before entering into a stock-loan or stock-borrow transaction.
- Establishing transaction limits by counterparty.
- Listing those securities in excess of SEC Rule 15c3-3 possession or control requirements as available to be loaned for any given day. Recalling those securities in deficits within the time frames required.
- Obtaining physical possession or control of all collateral.
- Ensuring that borrows are made in accordance with the requirements of Federal Reserve Regulation T.
- Marking to market all collateral daily and, if a deficit (within established guidelines) exists, obtaining additional collateral from the counterparty.
- Reconciling the stock-loan and stock-borrow subsidiary ledgers to the stock record (positions) and general ledger (contract amounts) daily. Out-of-balances are recorded as suspense items and researched immediately.
- Confirming transactions periodically on a basis that, at a minimum, complies with SEC Rule 17a-13 regarding the quarterly verification of securities.
- Listing transactions with unusually high or low rebate terms on an exception report for review by management.

6.67 *Repos and Reverse Repos.* Repo agreements are typically entered into to finance positions in government and government-agency securities (see Chapter 1). Reverse repo agreements are similar to stock borrow transactions, except that reverse repo agreements are generally executed in government and

government-agency securities and frequently relate to investment activities, in addition to meeting delivery requirements. Control and monitoring activities typically associated with repo and reverse repo agreements include—

- Reviewing counterparties for creditworthiness and obtaining master trade agreements and credit approval for counterparties before entering into a repo or reverse repo transaction.
- Establishing position and credit limits by counterparty.
- Reviewing presentation of offsetting transactions (netdown) to ensure that it complies with requirements of FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements—an interpretation of APB Opinion No. 10 and a modification of FASB Interpretation No. 39*.
- Obtaining collateral from the counterparty.
- Marking to market all collateral daily; if a deficit (within established guidelines) exists, additional collateral may be obtained from the counterparty.
- Reconciling the repo and reverse repo subsidiary ledgers to the stock record (positions) and general ledger (contract amounts) daily. Out-of-balances are recorded as suspense items and researched immediately.
- Periodically confirming transactions on a basis that, at a minimum, complies with SEC Rule 17a-13 regarding quarterly verification of securities.
- Listing transactions with unusually high or low interest terms on an exception report for review by management.

6.68 Bank Loan Financing. A broker-dealer may finance its proprietary or customer activity through collateralized bank loans. Such loans must be negotiated separately with each bank. Some of the control and monitoring activities typically associated with bank loan financing include—

- Ensuring that customer, noncustomer, and firm bank loans are separately maintained and that procedures are in place to prevent commingling of collateral.
- Maintaining separate accounts in the general ledger for each loan, with separate positions being maintained on the stock record for the securities collateralizing each loan.
- Ensuring that securities used to collateralize bank loans for customers are not fully paid or excess-margin securities, because such securities are required to be segregated pursuant to SEC Rule 15c3-3 possession or control requirements.
- Periodically confirming bank loan collateral on a basis that, at a minimum, complies with SEC Rule 17a-13 regarding the quarterly verification of securities.

SEC Requirements for Management's Report on Internal Control Over Financial Reporting[#]

6.69 As directed by Section 404 of the Sarbanes-Oxley Act of 2002, the Securities and Exchange Commission (SEC) adopted final rules requiring companies subject to the reporting requirements of the Securities Exchange Act of 1934, other than registered investment companies, to include in their annual reports a report of management on the company's internal control over financial reporting. See the SEC web site at www.sec.gov/rules/final/33-8238.htm for the full text of the regulation. This requirement is applicable to public companies. Therefore, privately held broker-dealers would not have to include in their annual reports a management's report on the company's internal control over financial reporting. However, for broker-dealers that are subsidiaries of public companies, auditors may perform additional procedures to be able to report on the consolidated entity's financial statements and internal control in accordance with the SEC requirements and PCAOB standards.

6.70 The SEC rules clarify that management's assessment and report is limited to *internal control over financial reporting*. Management is not required to consider other aspects of control, such as controls pertaining to operating efficiency. The SEC's definition of internal control encompasses the Committee of Sponsoring Organizations of the Treadway Commission (COSO) definition but the SEC does not mandate that the entity use COSO as its criteria for judging effectiveness.

[#] A company that is an "accelerated filer" as defined in Rule 12b-2 under the Securities Exchange Act of 1934 (generally, a U.S. company that has equity market capitalization over \$75 million and has filed at least one annual report with the commission), must begin to comply with the SEC rules regarding Section 404 of the Sarbanes-Oxley Act for its first fiscal year ending on or after Nov. 15, 2004. The deadline for non-accelerated filers and foreign private issuers to comply with these requirements was extended to July 15, 2006.

On August 9, 2006, the SEC issued two releases to grant smaller public companies and many foreign private issuers further relief from compliance with Section 404 of the Sarbanes-Oxley Act of 2002. The first release is a final rule extending for an additional year the deadline for foreign private issuers that are accelerated filers, but not large accelerated filers, and that file their annual reports on Form 20-F or Form 40-F, for initial compliance with the Section 404(b) requirement to provide an auditor's attestation report on internal control over financial reporting in their annual reports. This group of issuers will be required to comply only with the Section 404 requirement to include management's report in the Form 20-F or 40-F annual report filed for their first fiscal year ending on or after July 15, 2006. They will not need to comply with the requirement to provide the registered public accounting firm's attestation report until they file a Form 20-F or 40-F annual report for a fiscal year ending on or after July 15, 2007. [SEC Release No. 33-8730]

The second release consists of proposals for smaller public companies and for newly public companies. Specifically, the SEC is proposing to grant relief to smaller public companies by extending the date by which non-accelerated filers must start providing a report by management assessing the effectiveness of the company's internal control over financial reporting. The initial compliance date for these companies would be moved from fiscal years ending on or after July 15, 2007, until fiscal years ending on or after Dec. 15, 2007. The SEC also proposes to extend the date by which non-accelerated filers must begin to comply with the Section 404(b) requirement to provide an auditor's attestation report on internal control over financial reporting in their annual reports. This deadline would be moved to the first annual report for a fiscal year ending on or after Dec. 15, 2008. This proposed extension would result in all non-accelerated filers being required to complete only the management's portion of the internal control requirements in their first year of compliance with the requirements.

For newly public companies, the SEC is proposing to amend its rules so that a company would not be required to provide either a management assessment or an auditor attestation report until it has previously filed one annual report with the SEC. [SEC Release No. 33-8731]

Annual Reporting Requirements

6.71 Under the SEC rules, the company's annual 10-K must include:

1. *Management's Annual Report on Internal Control Over Financial Reporting.* This report on the company's internal control over financial reporting should contain:
 - a. A statement of management's responsibilities for establishing and maintaining adequate internal control over financial reporting.
 - b. A statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting.
 - c. Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. This discussion must include disclosure of any material weakness in the company's internal control over financial reporting identified by management. Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting.
 - d. A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.
2. *Attestation Report of the Registered Public Accounting Firm.* This is the registered public accounting firm's attestation report on management's assessment of the company's internal control over financial reporting.
3. *Changes in Internal Control Over Financial Reporting.* This report must disclose any change in the company's internal control over financial reporting that has materially affected or is reasonably likely to materially affect the company's internal control over financial reporting.

Quarterly Reporting Requirements

6.72 The SEC rules also require management to evaluate any change in the entity's internal control that occurred during a fiscal quarter and that has materially affected, or is reasonably likely to materially affect, the entity's internal control over financial reporting.

6.73 Additionally, management is required to evaluate the effectiveness of the entity's "disclosure controls and procedures" and issue a report as to their effectiveness on a quarterly basis. With these rules, the SEC introduced a new term, "disclosure controls and procedures," which is different from "internal controls over financial reporting" and much broader.

6.74 As defined, "disclosure controls and procedures" encompass the controls over all material financial *and nonfinancial information* in Exchange Act

reports. Information that would fall under this definition that would *not* be part of an entity's internal control over financial reporting might include the signing of a significant contract, changes in a strategic relationship, management compensation, or legal proceedings.

Internal Risk Management Control Systems of Consolidated Supervised Entities

6.75 In April 2004, the SEC adopted rule amendments under the Securities Exchange Act of 1934 that establish a voluntary, alternative method of computing deductions to net capital for certain broker-dealers that are part of 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.

6.76 According to the amended rules (Appendixes E and G to Rule 15c3-1, "Net Capital Requirements for Brokers or Dealers"), broker-dealers that use this alternative method of computing net capital are required to have both their internal audit function and external auditors perform specific procedures related to their internal risk management controls in accordance with Rule 15c3-4, "Internal Risk Management Control Systems for OTC Derivatives Dealers," under the Securities Exchange Act of 1934. The amended rules specify that only a *registered public accounting firm* (as that term is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 et seq.)) could act in the capacity of an external auditor for such broker-dealers. Under the rule, the external auditors would be required to review the internal risk management control system in accordance with procedures agreed upon by the broker-dealer, the external auditor conducting the review, and the SEC.

6.77 The five industry participants currently registered as CSEs made a proposal to the SEC in late 2005 to replace the requirements for an annual Accountants Report on Internal Risk Management Control Systems under Rule 15c3-1 Appendix G (b)(1)(iii)(B) with an emphasis on the role the Internal Audit Department (IAD) would play in reviewing such controls each year. IAD would provide appropriate feedback on the regular assessment, and operating effectiveness, of the Internal Risk Management Control System within CSE registrant firms covered by Rule 15c3-4 to both senior management and the Audit Committee. The SEC Division of Market Regulation has agreed to the proposal which is being implemented in 2006.

Review Requirements

6.78 The CSE registrants are required to demonstrate that the Internal Risk Management Control Systems (as defined in Rule 15c3-4) are included within IAD's universe of coverage, that IAD reviews the key elements of those activities on a periodic basis, and that the results of those reviews are reported to senior management and the Audit Committee, and are available for discussion with the SEC. In addition, IAD's periodic reviews must be conducted on a frequency and scope driven by a risk assessment program.

6.79 As part of the proposal, Internal Risk Management Control System reviews should be conducted by IAD at three levels:

1. *Risk Oversight and Governance*. This is generally executed through senior risk management oversight committees that establish

overall risk management policies. These committees cover, for example, credit and market risks. IAD would conduct periodic governance reviews that include, as relevant, examination of the constitution of charters, span of authority, reporting procedures, the breadth and appropriateness of committee membership, sufficiency of committee minutes or similar documentation, and the frequency of meetings.

2. *Functional Risk Management.* This is generally executed by independent dedicated risk management functions within each CSE and includes day to day risk management activities such as limit setting and monitoring, and firmwide risk aggregation. These dedicated risk management functions have responsibility for managing risks arising out of business activities, including market, credit, leverage, liquidity, legal, and operational risks. IAD would conduct periodic reviews of these risk management functions including, as relevant, examining policies and procedures, reporting lines, limit administration, escalation procedures for limit breaches, data accuracy and completeness, data security controls, testing and authorization controls over models, processes to establish internal credit ratings, and other activities relevant to each CSE's functional risk management.
3. *Business Level Risk Management.* This is generally executed by individual business/product areas within each CSE and includes day to day risk management activities such as limit monitoring, requests/approval process for limit adjustments, and transmission of risk data to the functional risk management areas. IAD would conduct periodic reviews of these risk management activities as a component of their business/product area audits

Communication Requirements

6.80 The scope of IAD's reviews of the Internal Risk Management Control System that will be regularly presented to the Audit Committee and the SEC's Division of Market Regulation will include the Risk Oversight and Governance and Functional Risk Management levels described above.

6.81 *Audit Committee Communications.* Periodically, but not less than annually, each CSE's IAD will present the following materials to their Audit Committee at a meeting where their Registered Public Accounting Firm (RPAF) is present:

1. A schedule detailing the status of the year's audit plan over the Internal Risk Management Control System, including projected delays, if applicable.
2. The rationale for any deferrals or delays in coverage.
3. A review of the results of such audits.

6.82 The Audit Committee minutes will reflect that the above topics were discussed, and will include any relevant matters raised by the RPAF. Prior to the Audit Committee meeting, the RPAF will have had the opportunity to review relevant reports and workpapers to be in a position to discuss IAD's coverage and findings related to the Internal Risk Management Control System, and to respond to other appropriate questions.

6.83 *Periodic Meetings between IAD and the Division of Market Regulation.*

The following specific items will be provided to the SEC's Division of Market Regulation in addition to materials already being provided during the recurring quarterly meetings relating to IAD's reviews of the Internal Risk Management Control System:

Quarterly meeting following Internal Audit's annual planning process:

1. IAD's universe of auditable entities comprising coverage over the Internal Risk Management Control System.
2. A schedule detailing actual audit coverage, of the universe listed in #1 above, for the past 2 years and projected coverage for the current and following year.

Each quarterly meeting:

1. A schedule detailing the status of the year's audit coverage of the Internal Risk Management Control System, including projected delays, if applicable.
2. A review of the results of completed audits relating to the Internal Risk Management Control System.
3. A schedule detailing any open and past due significant issues arising from the reviews of the Internal Risk Management Control System.
4. Organizational chart showing Internal Audit's independent reporting lines, if applicable due to any changes since the last meeting.

6.84 At the request of the SEC's Division of Market Regulation, RPAFs may meet annually with the Division of Market Regulation, with the consent of the CSE's management, to discuss matters relevant to the CSE's IAD review of the Internal Risk Management Control System.

Chapter 7

Accounting Standards

7.01 Generally accepted accounting principles (GAAP) apply to broker-dealers in the same manner as they apply to other industries; however, certain activities of broker-dealers' operations are unique. It is the purpose of this chapter to identify and discuss the accounting treatment for certain of those unique activities that are engaged in by broker-dealers. New broker-dealer activities may develop that will require accounting guidance to reflect their economic substance. The accounting principles that apply to the specific activities addressed in this chapter can be applied to other activities that are similar to those discussed. It should be noted that broker-dealers also prepare regulatory reports and supplemental information. Accounting and reporting requirements under GAAP may differ from broker-dealer regulatory accounting and reporting requirements stipulated by the Securities and Exchange Commission (SEC) and other regulatory organizations (see Chapter 3, "Regulatory Considerations"). In addition, the financial reporting practices and the recording of transactions discussed in this chapter may differ significantly from the tax basis of reporting.

Accounting Model*

7.02 A broker-dealer accounts for inventory and derivative positions (such as futures, forwards, swaps, and options) at fair value. (See the "Derivatives" section in this chapter for a discussion of FASB Statement No. 133, *Accounting*

* On September 15, 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, that provides enhanced guidance for using fair value to measure assets and liabilities. FASB Statement No. 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value and does not expand the use of fair value in any new circumstances. FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. Below is a brief discussion of some of the provisions of FASB Statement No. 157 that should be of interest to broker-dealers and their auditors.

FASB Statement No. 157 establishes the fair value hierarchy which prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date.

Among other matters, FASB Statement No. 157 precludes the use of a blockage factor. Paragraph 27 of FASB Statement No. 157 provides that "If the reporting entity holds a position in a single financial instrument (including a block) and the instrument is traded in an active market, the fair value of the position shall be measured within Level 1 as the product of the quoted price for the individual instrument times the quantity held. The quoted price shall not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price." Footnote 11 to this paragraph states that "The guidance in this Statement applies for positions in financial instruments (including blocks) held by all entities, including broker-dealers and investment companies within the scope of the AICPA Audit and Accounting Guides for those industries."

The guidance in FASB Statement No. 157 applies for derivatives and other financial instruments measured at fair value under FASB Statement No. 133, *Accounting for Derivative*

(continued)

for Derivative Instruments and Hedging Activities, as amended by FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*, FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, and FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*.) Most other assets, such as fixed assets,

(footnote continued)

Instruments and Hedging Activities, at initial recognition and in all subsequent periods. Therefore, FASB Statement No. 157 nullifies the guidance in footnote 3 of 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," which applied for derivatives (and other) instruments measured at fair value at initial recognition under FASB Statement No. 133. That guidance precluded immediate recognition in earnings of an unrealized gain or loss, measured as the difference between the transaction price and the fair value of the instrument at initial recognition, if the fair value of the instrument was determined using significant unobservable inputs. FASB Statement No. 157 provides, however, that for unobservable inputs the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability. Consistent with that objective, FASB Statement No. 157 clarifies that the fair value measurements should be adjusted for risk, that is, the amount market participants would demand because of the risk (uncertainty) inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique (a risk premium notion). Accordingly, a measurement (for example, a "mark-to-model" measurement) that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one in pricing the related asset or liability.

FASB Statement No. 157 also amends FASB Statement No. 133 to remove the similar guidance to that in EITF Issue No. 02-3, which was added by FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*.

FASB Statement No. 157 provides that if an input used to measure fair value is based on bid and ask prices (for example, in a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances should be used to measure fair value, regardless of where in the fair value hierarchy the input falls (Level 1, 2, or 3). FASB Statement No. 157 does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for fair value measurements within a bid-ask spread.

FASB Statement No. 157 clarifies that market participant assumptions also include assumptions about the effect of a restriction on the sale or use of an asset. A fair value measurement for a restricted asset should consider the effect of the restriction if market participants would consider the effect of the restriction in pricing the asset.

FASB Statement No. 157 also clarifies that a fair value measurement for a liability reflects its nonperformance risk (the risk that the obligation will not be fulfilled). Because nonperformance risk includes the reporting entity's credit risk, the reporting entity should consider the effect of its credit risk (*credit standing*) on the fair value of the liability in all periods in which the liability is measured at fair value under other accounting pronouncements, including FASB Statement No. 133.

FASB Statement No. 157 also expands disclosures about the use of fair value to measure assets and liabilities in interim and annual periods subsequent to initial recognition. The disclosures focus on the inputs used to measure fair value and for recurring fair value measurements using significant unobservable inputs (within Level 3 of the fair value hierarchy), the effect of the measurements on earnings (or changes in net assets) for the period. FASB Statement No. 157 encourages entities to combine the fair value information disclosed under FASB Statement No. 157 with the fair value information disclosed under other accounting pronouncements, including FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, where practicable.

The May 2007 edition of this Guide will be updated to reflect changes arising from FASB Statement No. 157.

Also, on January 25, 2006, the FASB issued an Exposure Draft of a Proposed Statement, *The Fair Value Option for Financial Assets and Financial Liabilities*. The fair value option project has two phases: This proposed Statement represents Phase 1, which addresses the fair value option for certain financial assets and financial liabilities. Phase 2 will consider permitting the fair value option for certain nonfinancial assets and nonfinancial liabilities and some of the financial assets and financial liabilities excluded from the scope of Phase 1.

This proposed Statement would create a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities on a contract-by-contract basis, with changes in fair value recognized in earnings as those changes occur. The Exposure Draft's comment period ended on April 10, 2006. A final Statement for Phase 1 is expected to be issued in the fourth quarter of 2006. The FASB's activity on Phase 2 will begin after a final Statement has been issued for Phase 1. Readers should be alert to any further developments.

accounts receivable, securities borrowed, securities purchased under agreements to resell (known as resale or reverse repurchase agreements or reverse repos), and exchange memberships owned, are reported at historical cost or at contract or the fair value of collateral to be returned. Obligations for short inventory positions are reported at fair value. Liabilities related to broker-dealer operations, such as fails to receive and securities sold under agreements to repurchase (known as repurchase agreements or repos), are recorded at contract amounts or the fair value of collateral to be returned. The fair value of a financial instrument is the price at which a willing buyer and a willing seller would enter into an exchange. Fair value is measured by management, taking into consideration all the relevant information available, and is usually determined for accounting purposes as of the end of the entity's business day in the principal location of the broker-dealer entity issuing financial statements.

7.03 Although broker-dealers value their portfolios at the time of the close of trading on the principal exchange on which the financial instruments are traded, significant events or price changes that occur after this time but before the end of the entity's business day should be considered in the valuation of the financial instruments. Related financial instruments may be traded in tandem, for example, as part of an arbitrage-trading strategy whose profitability is determined by the relative value of the financial instruments. It is appropriate to review the prices occurring on different exchanges or in different markets for all the individual financial instruments in the trading strategy at a given time in order to assign the proper value to all securities encompassed in that financial strategy.

7.04 Fair value is measured in a variety of ways depending on the nature of the instrument and the manner in which it is traded. Many financial instruments are publicly traded, and end-of-day market quotations are readily available. Quoted market prices, if available, are the best evidence of the fair value of a financial instrument. If quoted market prices are not available, management's best estimate of fair value should be based on the consistent application of a variety of factors available to management. These factors are discussed in the following paragraphs.

Financial Instruments Listed on a Recognized Exchange

7.05 Ordinarily, management values a financial instrument traded on a recognized exchange¹ based on quotations of completed transactions. A financial instrument traded on a recognized exchange on the valuation date is usually valued at the last quoted sales price. Such prices are published daily. In the case of a financial instrument listed on more than one recognized exchange, the financial instrument is valued at the last quoted sales price on the exchange on which the financial instrument is principally traded. Where appropriate, a composite quotation that reflects subsequent price changes in the financial instrument occurring on another exchange should be used. A financial instrument traded primarily on foreign exchanges is valued at the U.S.-dollar equivalent, generally at the closing price on the principal exchange where it is traded.

7.06 Quoted market prices provide the most reliable measure of fair value. Accordingly, quoted market prices are the appropriate basis for valuing financial instruments listed on recognized exchanges. However, in certain situations,

¹ Reference to a recognized exchange includes the National Association of Securities Dealers Automated Quotation (NASDAQ) System market.

the total market value of a financial instrument is not readily realizable (for example, if a broker-dealer makes the market in a financial instrument or owns a substantial block of a thinly traded financial instrument). Those situations should be considered in determining whether a lower value is appropriate for a particular financial instrument held by the broker-dealer, in order to properly reflect that financial instrument's fair value. Notes to the financial statements should disclose the following if financial instruments are valued at lower than quoted market prices:

- Description of the financial instrument
- Total value of the financial instrument as measured by the quoted market price
- Total value reported in the statement of financial condition
- Methods and significant assumptions used to value the instrument at lower than the quoted market price

Financial Instruments Not Listed on a Recognized Exchange But Having a Readily Available Market Price

7.07 Non-exchange-traded financial instruments are often traded in over-the-counter (OTC) markets by dealers or other intermediaries from whom market prices are obtainable. Quotations are available from various sources for many financial instruments traded regularly in the OTC market. Those sources include the financial press, various quotation publications and financial reporting services, and individual market makers.

7.08 A broker-dealer may adopt a policy that is applied on a consistent basis and that uses one of the following:

- An average of bid and asked prices
- Bid prices for long positions and asked prices for short positions
- Some average of price quotations of a representative selection of market makers quoting on a particular financial instrument
- A valuation within the range of bid and asked prices considered best to represent value in the circumstances

Asked prices should not be used for long positions nor should bid prices be used for short positions.

7.09 If there is a limited amount of trading activity for a financial instrument (that is, if the instrument is thinly traded), the reliability of the market quotation and other market information (for example, volume data) should be evaluated by management. In instances where the fair value as determined by management is lower than the market quotation, the financial instruments should be valued at such fair value.

Financial Instruments Not Having a Readily Available Market Price

7.10 A broker-dealer may have to determine the fair values of financial instruments for which there are no readily available price quotations or for which readily available price quotations are unreliable. These price quotations may be deemed unreliable because the financial instruments may have restrictions associated with them (such as not being registered) or may be thinly traded or

traded in a market where sales are infrequent. In such cases, it may be appropriate for these financial instruments to be valued at fair value as determined in good faith by management. To determine fair value, management should satisfy itself that—

- All appropriate factors relevant to the value of financial instruments for which price quotations are not readily available have been considered.
- The procedures for arriving at the fair value of each financial instrument are reasonable and consistently applied.
- The underlying documentation supports the fair value estimates.

7.11 To the extent considered necessary, management should take into consideration all indications of value that are available in determining the fair value assigned to a particular financial instrument. This Guide does not purport to delineate all factors that may be considered; however, the following is a list of certain factors:²

- Financial standing of the issuer
- Business and financial plan of the issuer
- Cost at date of purchase
- Size of position held and the liquidity of the market
- Contractual restrictions on salability
- Pending public offering with respect to the financial instrument
- Pending reorganization activity affecting the financial instrument (such as merger proposals, tender offers, debt restructurings, and conversions)
- Reported prices and the extent of public trading in similar financial instruments of the issuer or comparable companies
- Ability of the issuer to obtain needed financing
- Changes in the economic conditions affecting the issuer
- A recent purchase or sale of a security of the company
- Pricing by other dealers in similar securities

7.12 The information so considered and the basis for the decision should be documented.

7.13 Management may use a variety of methods to assist in determining the valuation of a financial instrument. These methods include analogy to reliable quotations of similar financial instruments, pricing models, matrix pricing, and other formula-based pricing methods. These methodologies incorporate factors for which published market data may be available. For instance, the mathematical technique known as *matrix pricing* may be used to determine the values based on market data available with respect to the issue and similar issues without exclusive reliance on issuer-specific quoted market prices.

7.14 Pricing methods may also be based on a multiple of earnings or a discount (or less frequently, a premium) from market of a similar, freely traded

² The SEC's *Codification of Financial Reporting Policies* provides guidance on the factors to be considered, and on the methods used to value securities for which market quotations are not readily available. Paragraphs 22–29 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, specifically address financial instruments with no quoted market prices.

security; on a yield to maturity with respect to debt issues; or on a combination of these and other methods. In addition, with respect to derivative products, other factors (such as volatility, anticipated future interest rates, and term to maturity) should be considered. (The Group of Thirty Report, *Derivatives Practices and Principles*,³ contains several recommendations regarding dealers' pricing, including that derivative portfolios be valued based on mid-market levels less specific adjustments.) If such methods are used, management should continuously review the appropriateness of such methods to satisfy themselves that the resulting valuations are fair.

Trade-Date Versus Settlement-Date Accounting

7.15 Broker-dealers execute a wide variety of transactions in financial instruments for their own accounts (proprietary transactions, also referred to as principal transactions) or on behalf of customers (agency transactions). The transactions usually involve at least two important dates.

Trade date—The date on which an agreement (an executory contract) is entered into, setting forth the important aspects of the transaction (such as a description of the instruments, quantity, price, delivery terms, and so forth).

Settlement date—The date on which the financial instrument is required to be delivered to the purchaser and consideration paid. Depending on the particular transaction, the settlement date could be as early as the same day as the trade date or as far away as months (and sometimes more than a year) after the trade date.

7.16 The settlement date is generally established by convention or by regulations of the market in which the transaction is executed (for instance, regular-way trades executed on the floor of a stock exchange); for certain types of transactions, the settlement date is based on the terms agreed to by the parties (for instance, forward transactions).

7.17 Although the terms for each type of transaction may differ in many respects, they tend to have the following two major aspects in common.

- a. On the trade date, the purchaser assumes the risks and rewards of further changes in the value of the underlying financial instrument.
- b. On the settlement date, the seller is required to deliver and the purchaser is required to pay for the financial instrument.

Proprietary/Principal Transactions

7.18 Risk, benefits, and economic potentials are created and conveyed at the trade date (that is, the inception of the contract), which is when the major terms have been agreed to by the parties. In order to properly reflect the economic effects of purchase and sale transactions for financial instruments (that is, to reflect the assumption of the risks and rewards resulting from changes in the value of financial instruments), broker-dealers should account for the changes in value relating to all proprietary/principal transactions on a trade-date basis.

³ Group of Thirty. *Derivatives: Practices and Principles*. Washington, DC: Group of Thirty, 1993, and *Enhancing Public Confidence in Financial Reporting*. Washington D.C: Group of Thirty, 2003. [Group of Thirty, 1990 M Street, N.W., Washington, DC 20036].

7.19 The statement of financial condition should reflect all regular-way trades on an accrual or trade-date basis. For example, if the broker-dealer purchased financial instruments for its own account on the date of the statement of financial condition, the transaction would be reflected in the broker-dealer's inventory with a corresponding credit to net receivable or payable for unsettled regular-way trades. Regular-way trades include the following. (a) All transactions in exchange-traded financial instruments that are expected to settle within the standard settlement cycle of that exchange (for example, three days for United States securities exchanges). (b) All transactions in cash-market-traded financial instruments that are expected to settle within the time frame prevalent or traditional for each specific instrument (for example, for U.S. government securities, one or two days). For physical commodities (such as lumber, crude oil, and precious metals), the prevalent trade practice for recording such transactions should be followed, which is typically when title passes.

7.20 The risk of nonperformance of regular-way settling trades is minimal given the following. (a) They are fully collateralized on the trade date. (b) The period of time between trade date and settlement date is reasonably short. (c) Most equity, U.S. Government, and mortgage-backed agency securities are affirmed by both parties to the trade and settle net through a clearing organization. Accordingly, payables and receivables arising from these unsettled regular-way transactions may be recorded net in an account titled net receivable (or payable) for unsettled regular-way trades. Paragraph 7 of FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, permits this accounting treatment.

7.21 Certain other contracts are also recognized in the financial statements of broker-dealers on a trade-date basis. Contracts that are defined as derivative instruments according to FASB Statement No. 133 shall be measured at fair value* and recognized in the statement of financial condition as either assets or liabilities depending on the rights or obligations under the contracts. The fair values of unsettled delayed-delivery and to-be-announced securities (TBA) trades should be based on prices for forward-settling trades. For example, a foreign-exchange forward contract may call for a party to deliver one million U.S. dollars in exchange for two million German marks at a specified future date. Under current reporting practice, the party would not record a receivable for the German marks or a payable for the U.S. dollars. Rather, a net amount reflecting the fair value of the position would be reported in the statement of financial condition. The fair values of these contracts or of accrued receivables or payables arising from the contracts may be offset only if the provisions of FASB Interpretation No. 39 are met.

7.22 If the exchange does not occur on the contracted settlement date (referred to as a fail-to-deliver or fail-to-receive), these transactions should be recognized on the statement of financial condition as fails-to-receive or fails-to-deliver. The receivables and payables resulting from these failed transactions may be netted for financial statement reporting purposes to the extent the provisions of FASB Interpretation No. 39 are met.

Agency Transactions

7.23 Transactions executed by broker-dealers as agents for customers are not reflected in the statement of financial condition of the broker-dealer unless

* See footnote * in paragraph 7.02.

the transaction fails to settle on the contracted settlement date. Unlike a principal transaction, where the broker-dealer is the counterparty to the transaction with the customer and thus would have the securities transactions flow through its inventory as it is *acting in a dealer capacity*, in an agency transaction, the broker-dealer is simply a middleman between two counterparties and thus the securities transactions do not flow through its inventory as it is *acting in a broker capacity*. Because the broker-dealer typically delivers cash or financial instruments on behalf of the customer, if the customer fails on the settlement date, the broker-dealer is required to record the transaction (for example, as a fail-to-receive from customer, payable to customer, or stock borrowed or loaned on behalf of customer). The commission income and related expenses are accrued by the broker-dealer on the trade date, because substantially all the efforts in generating the commissions have been completed.

Statement-of-Financial-Condition Considerations

Due From and Due to Other Broker-Dealers and Clearing Organizations

7.24 Amounts due from and due to other broker-dealers and clearing organizations may arise from the following:

- Net receivables or payables arising from unsettled regular-way transactions
- Securities borrowed and loaned
- Failed settlement transactions
- Clearing organization balances
- Commissions
- Deposits

7.25 Balances arising from the foregoing, with the exception of the net payable or receivable arising from unsettled transactions, are reported gross on the statement of financial condition, unless the provisions of FASB Interpretation No. 39 are met. For example, a broker-dealer may report on a net basis payables and receivables associated with clearing through a clearing organization that provides for and guarantees net settlement balances, because the criteria of FASB Interpretation No. 39 are met. Appendix D-43 to the *EITF Abstracts* contains the FASB staff response to inquiries about the nature of support required for an assertion in financial statements that a right of setoff is enforceable at law.

Secured Borrowings

7.26 Broker-dealers enter into a variety of transactions that may be required to be accounted for either as sales of securities or as secured borrowings,⁴ depending on the terms of the particular transaction. These include securities borrowing and lending transactions, repurchase (repo) and reverse repurchase (reverse repo) agreements, and dollar repurchase agreements (dollar rolls).

7.27 Securities lending transactions are documented as loans of securities in which the borrower of securities generally is required to provide collateral

⁴ Secured borrowings, as that term is used in FASB Statement No. 140, are also sometimes referred to as *collateralized financings*.

to the lender of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities borrowed. If the collateral is cash, the lender of securities typically earns a return by investing that cash at rates higher than the rate paid or rebated to the borrower. If the collateral is other than cash, the lender of securities typically receives a fee.

7.28 Repo and reverse repo agreements are typically documented as sales/purchases of securities with forward purchase/sales contracts. In a repo agreement, a security is sold with an agreement to repurchase the security from the buyer; in a reverse repo agreement, a security is purchased with an agreement to resell the security to the seller-lender at a stated price plus interest at a specific date or in specified circumstances.⁵

7.29 Dollar rolls are documented as agreements to sell and repurchase similar but not identical securities. Dollar rolls differ from regular repo agreements in that the securities sold and repurchased, which are usually of the same issuer, are represented by different certificates, are collateralized by different but similar collateral (for example, single-family residential mortgages), and generally have different principal amounts. The most common types of dollar rolls are fixed-coupon and yield-maintenance arrangements.

7.30 FASB Statement No. 140 sets forth standards for distinguishing transfers of financial assets that are to be accounted for as sales from transfers that are to be accounted for as secured borrowings.[†] Paragraph 9 of FASB Statement No. 140 states:

A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

- a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 27 and 28).

⁵ In certain industries, the terminology is reversed.

[†] In March of 2006 the FASB issued FASB Statement No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*, which simplifies the accounting for servicing assets and liabilities, such as those common with mortgage securitization activities. Specifically, FASB Statement No. 156 addresses the recognition and measurement of separately recognized servicing assets and liabilities and permits an entity to elect to carry servicing assets and liabilities at fair value through earnings, which may simplify efforts to obtain hedge-like accounting. Entities should adopt FASB Statement No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including interim financial statements, for any period of that fiscal year.

In August 2005, the FASB issued a related exposure draft, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, which would revise or clarify the derecognition requirements for financial assets and the initial measurement of interests related to transferred financial assets that are held by a transferor. Specifically, the proposed Statement seeks to (a) clearly specify the circumstances that require the use of a qualifying special-purpose entity (SPE) in order to derecognize all or a portion of financial assets, (b) provide additional guidance on permitted activities of qualifying SPEs, (c) eliminate the prohibition on a qualifying SPE's ability to hold passive derivative financial instruments that pertain to beneficial interests held by a transferor, and (d) revise the initial measurement of interests related to transferred financial assets held by a transferor. The final Statement is expected to be issued in the first quarter of 2007. Readers should be alert to the issuance of the final Statement.

- b. Each transferee (or, if the transferee is a qualifying special-purpose entity (SPE) (paragraph 35[†]), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (paragraphs 29–34).
- c. The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 47–49) or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call (paragraphs 50–54).

If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet these criteria for a sale, the transfer is to be accounted for by the transferor and transferee as a secured borrowing with a pledge of collateral. (The paragraphs referenced in paragraph 9 of FASB Statement No. 140 provide guidance on implementing the specified sale criteria.)

7.31 Paragraph 93 of FASB Statement No. 140 describes the accounting for securities lending transactions accounted for as secured borrowings in terms of—

cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as "collateral" is considered the amount borrowed, the securities "loaned" are considered pledged as collateral against the cash borrowed, and reclassified as set forth in paragraph 15(a), and any "rebate" paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed.

Paragraph 94 of FASB Statement No. 140 states that the transferor of securities being "loaned" accounts for cash received in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash received shall be recognized as the transferor's asset—as shall investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash. If securities that may be sold or repledged

[†] In February of 2006 the FASB issued FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*, which allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. Among other matters, FASB Statement No. 155 amends paragraphs 35(c)(2) and 40 of FASB Statement No. 140 to eliminate the prohibition on a qualifying SPE from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument.

FASB Statement No. 155 also eliminates the interim guidance in FASB Statement No. 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," which provides that beneficial interests in securitized financial assets are not subject to the provisions of FASB Statement No. 133.

FASB Statement No. 155 is effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of FASB Statement No. 155 may also be applied upon its adoption for hybrid financial instruments that had been bifurcated under paragraph 12 of FASB Statement No. 133 prior to the adoption of FASB Statement No. 155. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period, for that fiscal year.

are received, the transferor of the securities being "loaned" accounts for those securities in the same way as it would account for cash received. The accounting for noncash collateral by the debtor (or obligor) and the secured party depends on whether the secured party has the right to sell or repledge the collateral and on whether the debtor has defaulted.⁶ Paragraph 15 of FASB Statement No. 140 provides guidance on accounting for collateral.

7.32 Paragraph 100 of FASB Statement No. 140 states the following with respect to repurchase agreements.

As with securities lending transactions, under many agreements to repurchase transferred assets before their maturity the transferor maintains effective control over those assets. Repurchase agreements that do not meet all the criteria in paragraph 9 shall be treated as secured borrowings. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as the securities sold, qualify as borrowings if the return of substantially the same (paragraph 48) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

7.33 Balances arising from securities lending transactions that are accounted for as secured borrowings are reported gross on the statement of financial condition. Because securities-borrowed and securities-loaned transactions do not typically have explicit settlement dates, they do not meet the requirement, in paragraph 5c of FASB Interpretation No. 39, that the reporting party intends to set off. Balances arising from repo transactions treated as secured borrowings should be reported gross in the statement of financial condition unless all of the provisions of FASB Interpretation No. 41, *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements*, are met. FASB Interpretation No. 41 may be applied only to repo and reverse repo transactions.

Exchange Memberships Owned or Contributed

7.34 The accounting for exchange memberships depends on the rights they convey and the reasons they are held as assets:

- a. Exchange memberships should be accounted for at cost or at a lesser amount if there is an other-than-temporary impairment in value if they represent (a) both an ownership interest and the right to conduct business on the exchange, which are owned by a broker-dealer and held for operating purposes, or (b) an ownership interest, which must be held by a broker-dealer to conduct business on the exchange.
- b. Exchange memberships should be accounted for as intangible assets in accordance with FASB Statement No. 142, *Goodwill and Other Intangible Assets*, if they represent only the right to conduct business on an exchange. Such memberships may have finite or indefinite lives based on the terms of the arrangement and the estimated life of the membership.

⁶ Cash "collateral," sometimes used, for example, in securities lending transactions (paragraphs 91–95 of FASB Statement No. 140), shall be derecognized by the payer and recognized by the recipient, not as collateral, but rather as proceeds of either a sale or borrowing.

- c. Exchange memberships contributed for the use of the broker-dealer and subordinated to claims of general creditors should be accounted for at fair value with an equal and offsetting amount accounted for as liabilities subordinated to claims of general creditors.

Suspense Accounts

7.35 Because of the number of transactions that take place when trades are cleared for the broker-dealer or its customers, unreconciled differences and trading errors occur. Unreconciled differences are recorded at the amount of the transaction with an appropriate valuation account until a determination of the cause of the differences is made and the differences are resolved. Trading errors are recorded in the broker-dealer's error suspense account until they are resolved. The underlying securities are marked to market, and the gain or loss is recognized in income. A broker-dealer often has several suspense accounts to facilitate the resolution and identification of differences.

Conditional Transactions

7.36 Certain transactions (for example, those for when-issued securities) are, by their nature, conditional; that is, their completion is dependent on the occurrence of a future event or events. However, contracts for the purchase or sale of when-issued securities or other securities that do not yet exist, that are derivative instruments, as defined by FASB Statement No. 133, as amended, and that do not meet the criteria for exclusion discussed in paragraph 59(a) of that Statement are subject to the requirements of that Statement. Based on guidance in paragraph 59(a) of FASB Statement No. 133, as amended, the regular-way security trades exception discussed in paragraph 10(a) may be applied to certain securities referred to as when-issued securities or other securities that do not yet exist, even if they have net settlement provisions or a market mechanism exists to facilitate net settlement if it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery of a security when it is issued. (See the "Derivatives" section in this chapter for a discussion of FASB Statement No. 133, as amended). For those transactions in which completion is assured beyond a reasonable doubt, the recording of the transactions and related profit and loss should be the same as for unconditional transactions. For those transactions in which completion is not assured beyond a reasonable doubt, only mark-to-market losses should be provided, while market-value gains should be deferred until the uncertainty is eliminated.

Leveraged Buyouts and Bridge Loans

7.37 Some broker-dealers may make investments in the form of equity or provide financing to another entity in connection with financial-restructuring transactions. These investments may take many forms, including a direct investment or an investment in a company (sometimes referred to as a *bridge company*) that is established for the purpose of accumulating funds from several sources sufficient to make the investment. These investments should be presented at fair value, which is usually based on management's good-faith determination in the absence of a ready market. Prevalent industry practice is generally not to consolidate majority-owned investee companies because control of such companies is likely to be temporary (refer to paragraph 2 of Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, as amended by FASB Statement No. 94, *Consolidation of All Majority-owned*

Subsidiaries, and FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*).^{||} Although FASB Statement No. 144 amended paragraph 2 of ARB No. 51 to eliminate the temporary control exception to consolidation, that amendment was not intended to apply to the prevalent industry practice described above.

Asset Securitizations[#]

7.38 The complexity of securitized products has increased significantly because of the nature of underlying collateral, the complexity of the structure (for example, residual tranches and interest- and principal-only strips), and the depth of markets. Such factors have affected the accounting and valuation of those products. Broker-dealers may acquire, either through market purchases or through the underwriting process, securities arising from asset securitizations. Those securities should be marked to market in accordance with the guidelines discussed previously. In addition, certain of those securities may raise issues about whether the underlying legal entity should be consolidated by the broker-dealer. FASB Statement No. 140[†] provides guidance on the securitization of financial assets held by broker-dealers and for other transfers of financial assets involving special-purpose entities (SPEs). In a typical asset securitization transaction, a company transfers assets to a special-purpose vehicle (SPV) or variable interest entity (VIE) in exchange for cash or securities issued by the SPV or VIE. Many securitization vehicles meet the FASB Statement No. 140 definition of a qualifying SPE. Qualifying SPEs are not consolidated under guidance in FASB Statement No. 140. Also, FASB Staff Position (FSP) FAS

^{||} The FASB has on its agenda a long-term project entitled *Consolidations: Policy and Procedure* to develop comprehensive accounting guidance on accounting for affiliations between entities, including reconsideration of ARB No. 51, *Consolidated Financial Statements*. The International Accounting Standards Board (IASB) also has an active project on its agenda to reconsider its guidance in this area. In April 2004, the IASB and FASB agreed that an objective of both of their projects is the development of a common, high-quality standard on consolidation policy. The objective of this research project is to identify and develop plans for the next steps in achieving the FASB's long-term objectives, including plans for coordinating the activities of the FASB with those of the IASB. The FASB began those staff research and planning activities in late 2005.

[#] In February of 2006 the FASB issued FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*, which allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. FASB Statement No. 155 also:

- a. Clarifies which interest-only strips and principal-only strips are not subject to the requirements of FASB Statement No. 133
- b. Establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation
- c. Clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives
- d. Amends FASB Statement No. 140 to eliminate the prohibition on a qualifying SPE from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument.

FASB Statement No. 155 is effective for all financial instruments acquired, issued, or subject to a remeasurement (new basis) event occurring after the beginning of an entity's first fiscal year that begins after September 15, 2006. The fair value election provided for in paragraph 4(c) of FASB Statement No. 155 may also be applied upon its adoption for hybrid financial instruments that had been bifurcated under paragraph 12 of FASB Statement No. 133 prior to the adoption of FASB Statement No. 155. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period, for that fiscal year.

[†] See footnote † in paragraph 7.30.

140-2, *Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140*,** addresses whether in certain circumstances an SPE would fail to meet the conditions of a qualifying SPE under the current requirements of FASB Statement No. 140. Securitization vehicles that do not qualify as qualifying SPEs need to be evaluated under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (Interpretation No. 46R), to determine if the broker-dealer is the primary beneficiary of the VIE and therefore should consolidate the VIE or if the broker-dealer holds a significant variable interest in the VIE and should make the appropriate disclosures.

Variable Interest Entities

7.39 FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (Interpretation No. 46R), an interpretation of ARB No. 51, addresses consolidation by business enterprises of variable interest entities with certain characteristics, as described in the Interpretation. Variable interest entities refer to entities subject to consolidation according to the provisions of the Interpretation. FASB Interpretation No. 46R clarifies the application of ARB No. 51 to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. Paragraphs 23 through 26 of the Interpretation include disclosure requirements. The FASB has issued several FSPs related to Interpretation No. 46R that may be of interest to broker-dealers and their auditors.†† Please refer to the FASB Web site at www.fasb.org for the status of FSPs at any point.

Derivatives††

7.40 FASB Statement No. 133, as amended, establishes accounting and reporting standards for derivative instruments, including certain derivative

** FSP FAS 140-2 was issued on November 9, 2005, and became effective upon issuance. Please refer to FASB Web site for the full text of this FSP.

†† In April 2006, the FASB issued FSP FIN 46(R)-6, *Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)*, which addresses how a reporting enterprise should determine the variability to be considered in applying FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*. An enterprise shall apply the guidance in this FSP prospectively to all entities (including newly created entities) with which that enterprise first becomes involved and to all entities previously required to be analyzed under Interpretation 46(R) when a reconsideration event has occurred pursuant to paragraph 7 of Interpretation 46(R) beginning the first day of the first reporting period beginning after June 15, 2006. Early application is permitted for periods for which financial statements have not yet been issued. Retrospective application to the date of the initial application of Interpretation 46(R) is permitted but not required. Retrospective application, if elected, must be completed no later than the end of the first annual reporting period ending after July 15, 2006. Please refer to the FASB Web site at www.fasb.org for more information.

In September 2005 the Professional Issues Task Force (PITF) of the AICPA issued Practice Alert 2005-01, *Auditing Procedures With Respect to Variable Interest Entities*, the purpose of which is to provide guidance to auditors of nonissuers in planning and performing auditing procedures with respect to variable interest entities. This Practice Alert can be accessed at the AICPA Web site at www.aicpa.org/download/auditstd/pract_alert/pa_2005_1.pdf.

†† In February of 2006 the FASB issued FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*, which allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. It should be noted that hybrid financial instruments that are elected to be accounted for in their entirety at fair value cannot be used as a hedge instrument in a FASB Statement No. 133 hedge. However, an entity may still elect to separately account for an embedded derivative so that it is eligible as a hedging instrument under FASB Statement No. 133. For more information on FASB statement No. 155 see the footnote to the "Asset Securitizations" section of this chapter. See FASB Web site at www.fasb.org for full text of FASB Statement No. 155.

instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities.⁷ Paragraph 6 of FASB Statement No. 133 states that a derivative instrument is a financial instrument or other contract with all three of the following characteristics:

- a. It has (1) one or more underlyings and (2) one or more notional amounts⁸ or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required. [footnote omitted]
- b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- c. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Notwithstanding the above characteristics, loan commitments that relate to the origination of mortgage loans that will be held for sale, as discussed in paragraph 21 of FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (as amended), shall be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender). Paragraph 10(i) of FASB Statement No. 133, as amended, provides a scope exception for the accounting for loan commitments by issuers of certain commitments to originate loans and all holders of commitments to originate loans (that is, the potential borrowers). When recognizing certain loan commitments registrants should also consider guidance provided in the SEC Staff Accounting Bulletin No. 105, *Loan Commitments Accounted for as Derivative Instruments*,^{|||} which provides interpretive guidance and emphasizes certain disclosure requirements that may be relevant in the context of mortgage banking activities.

Broker-dealers enter into derivative transactions to deal, to take proprietary positions, to effect economic hedges of instruments in other trading portfolios, to execute arbitrage strategies, or to hedge long-term debt or long-dated resale and repurchase transactions.

7.41 FASB Statement No. 133, as amended, requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial condition and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (a) a hedge of the exposure

⁷ Broker-dealers mark investments in trading securities and hedges to market. Auditors should be aware of this practice as they review the provisions of FASB Statement No. 133, as amended.

⁸ Sometimes other names are used. For example, the notional amount is called a face amount in some contracts.

^{|||} In February 2005, the AICPA published a draft of a proposed Practice Aid, *Illustrative Disclosure on Derivative Loan Commitments*, intended to provide illustrations of disclosures of derivative loan commitments in accordance with the reporting and disclosure guidance cited in SEC SAB No. 105, *Loan Commitments Accounted for as Derivative Instruments*. The practice aid includes examples of illustrative disclosures for each of the requirements cited in SAB No. 105. Disclosures in the practice aid include registrants' methods and assumptions used to estimate the fair values of derivative loan commitments and any associated hedging strategies. The provisions of SAB No. 105 must be applied to loan commitments accounted for as derivatives that were entered into after March 31, 2004.

The proposed practice aid is intended to provide "best practices" and is not authoritative. It is available on the AICPA's Web site at www.aicpa.org/download/members/div/acctstd/lllustrative_Disclosure_on_Derivative_Loan_Commitments.pdf for a short informal comment period.

to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (b) a hedge of the exposure to variable cash flows of a recognized asset or liability, or of a forecasted transaction, or (c) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign-currency-denominated forecasted transaction. The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation. FASB Statement No. 133 (paragraphs 44–47) also contains extensive disclosure requirements. Readers should refer to the full text of the Statement when considering accounting and reporting issues related to derivative instruments and hedging activities.

7.42 Derivatives entered into by dealers in connection with their dealing activities should be carried at fair value with resultant gains and losses reported currently in income. Quoted market prices provide the most reliable fair value for derivatives traded on a recognized exchange. Fair value for derivatives not traded on a recognized exchange is generally considered to be the value that could be realized through termination or assignment of the derivative. Although FASB Statement No. 107 provides guidance in determining fair value, there is no standard for determining fair value of all derivatives. Common valuation methodologies for an interest rate swap incorporate a comparison of the yield of the swap with the current treasury security yield curve and swap to treasury spread quotations, or the current swap yield curve. The swap yield curve is derived from quoted swap rates. Dealer bid and offer quotes are generally available for basic interest rate swaps involving counterparties whose securities are investment-grade. (The Group of Thirty Report, *Derivatives Practices and Principles*, contains several recommendations regarding dealer pricing, including that derivatives portfolios be valued based on mid-market levels less specific adjustments.) Factors that could influence the valuation of an individual derivative include the counterparty's credit standing and the complexity of the derivative. If those factors differ from those basic factors underlying the quote, an adjustment to the quoted price should be considered.*

7.43 In determining a derivative's value, consideration should be given to recognizing and providing for credit and liquidity risk and the operational and administrative costs associated with the management of derivative portfolios. The methods for determining the amount of credit risk and operational costs may differ among dealers.

Soft-Dollar Arrangements

7.44 The term *soft dollars* is used to describe an arrangement in which a broker-dealer provides research to a customer in return for trade order flow (a certain volume of trades) from that customer. This generates commission income for the broker-dealer. Many of these agreements are oral, and the value of the research to be provided is typically based on a percentage of commission income. Soft-dollar customers are typically institutional investors or money managers. Soft-dollar research may be generated either internally by the broker-dealer or purchased by the broker-dealer from a third party.

7.45 Since the 1970s, when soft dollars were first used, some broker-dealers and money managers have used soft dollars to cover transactions or

* See footnote * in paragraph 7.02.

expenses not associated with research. These types of transactions are governed by section 28(e) of the Securities Exchange Act of 1934, which allows the paying of a brokerage commission if the manager determines in good faith that the commission is reasonable in relation to the value of the brokerage and research services provided.

7.46 At the date of the statement of financial condition, the broker-dealer should analyze both the commission income generated from soft-dollar customers and the research provided to the soft-dollar customers to determine whether a liability should be accrued for research due to customers based on the commission income generated or whether any soft dollar expenses have been prepaid and need to be deferred. The realizability of any prepaid expenses must be evaluated as of the financial statement date.

Mandatorily Redeemable Instruments

7.47 FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, 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.") Such obligation may arise from the terms of the operating, partnership or incorporation agreement, or the operation of state law.

7.48 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 report minimal or no equity in their GAAP financial statements. From a regulatory standpoint, application of FASB Statement No. 150 can: (i) cause a broker-dealer to fall below its minimum net capital requirements under Rule 15c3-1(a), or (ii) cause its subordinated debt to debt-equity total to increase above the 70 percent limit set forth in Rule 15c3-1(d). Broker-dealers may have amended, or need to amend, partnership, operating (such as limited liability company), shareholder, or other agreements to avoid the potential adverse impacts of FASB Statement No. 150 on net capital.

Statement-of-Income/Loss Considerations

Underwriting Revenues and Expenses

7.49 There are several different ways in which a broker-dealer may participate in the underwriting of a new issue of securities. The broker-dealer may be the managing or lead underwriter, a member of the syndicate, or a member of the selling group.

7.50 Such participation may be on one of the following bases:

- Firm commitment

- Standby
- Best efforts
- All or none

7.51 In connection with its participation in an underwriting of securities, a broker-dealer may receive various types of revenues as well as incur various related expenses. Such revenues include management fees (in the case of the lead or comanaging underwriter), underwriting fees (in the case of the lead underwriter and other members of the syndicate), and selling concession fees (in the case of all selling group members). The related expenses include but are not limited to marketing and advertising fees, legal fees, stabilization costs, and the other costs associated with setting up the syndicate group. These expenses are accumulated by the lead underwriter and are allocated to the other members of the syndicate on a pro rata basis.

7.52 The fee revenue relating to the underwriting commitment should be recorded when all significant items relating to the underwriting cycle have been completed and the amount of the underwriting revenue has been determined. This will generally be at the point at which all of the following have occurred (which may or may not be prior to the settlement date of the issue):

- The issuer's registration statement has become effective with the SEC, or other offering documents are finalized (as opposed to the closing or settlement date).
- The broker-dealer has made a firm commitment for the purchase of the shares or debt from the issuer.
- The broker-dealer has been informed of the exact number of shares or the principal amount of debt that it has been allotted (if it is not the lead underwriter of an undivided offering).

7.53 Many of the related underwriting expenses described above are incurred prior to the actual issuance of the securities. Such expenses are deferred and recognized at the time the related revenues are recorded. In the event that the transaction is not completed and the securities are not issued, the firms that have agreed to participate in the costs associated with the underwriting write those costs off to expense.

7.54 With respect to the underwriting of issues that trade prior to the settlement date, the broker-dealer should mark-to-market any shares that it is firmly committed to purchase but that have not yet been subscribed to by customers.

Mutual Fund Distribution Costs

7.55 Broker-dealers may contract with one or more mutual funds to act as the registered distributor of the mutual fund's shares, assisting the fund in selling and distributing its shares. If a broker-dealer undertakes the responsibility for selling and distributing fund shares, it will incur different types of costs, the most common of which are commissions paid to those of its representatives who arrange fund sales. To compensate a broker-dealer for those selling efforts, mutual funds may establish some form of a fund-charge and shareholder-commission structure that provides fees to the broker-dealer either at the time of sale or over a specified period of time. Two common forms of compensation are the following:

- A front-end commission paid to the broker-dealer by the fund shareholder at the time of sale
- A 12b-1 distribution fee, which is paid by the fund over a period of time based on a percentage of the fund's daily net asset levels, together with a deferred sales charge, which is a commission paid to the broker-dealer by the shareholder at the time the shareholder exits the fund. Deferred sales charges are often charged to the shareholder in decreasing amounts over time.

7.56 A front-end commission should be recorded in full by the broker-dealer at the time it is earned (the trade date). With respect to 12b-1 fees and deferred sales charges, the broker-dealer generally defers its incremental direct costs associated with the selling of the fund shares (such as sales representatives' commissions and direct marketing costs) and amortizes these costs over the period in which the fees from the fund or fund shareholders are expected to be received. Indirect costs associated with selling the fund shares are expensed as incurred. Fees from the funds or fund shareholders are recognized when earned (see FASB EITF Issue No. 85-24, "Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge," and FSP EITF 85-24-1, *Application of EITF Issue No. 85-24, "Distribution Fees by Distributors of Mutual Funds That Do Not Have a Front-End Sales Charge"*).

Half-Turn Convention

7.57 Commissions on certain contracts, such as commodity futures and options, may be billed to customers on a round-turn basis. Even though the round-turn commissions may be reflected in the customer's account upon entering into the transaction or on the date of the round turn, this commission income should be recognized in the statement of income on a half-turn basis.

Interest, Dividends, and Rebates

7.58 The income statement classification of interest, dividends, and rebate income and expense varies, because certain transactions are entered into as financings while others are entered into as part of trading strategies.

7.59 Stock-loan and repo transactions may be entered into for the purpose of financing positions (such as in lieu of a bank loan). If such transactions are accounted for as financing transactions (see the discussion in this chapter entitled "Secured borrowings," that begins with paragraph 7.26), the rebate or interest expense should be reflected in the income statement as an expense separate and apart from any trading gains or losses.

7.60 However, broker-dealers frequently enter into matched-stock borrow and loan transactions as a finder or conduit, or enter into repo and reverse repo agreements as part of a matched-book trading strategy. Further, complex trading strategies often involve numerous long and short positions in different products, so that those positions reflect a trading position that is different from its individual components (for example, box spreads, conversions, and reversals). For those activities, the resulting income and expense may be reflected net in the income statement, with disclosure of the gross components either on the face of the income statement or in the notes to the financial statements.

Costs Associated With Exit or Disposal Activities

7.61 FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, provides guidance on accounting for costs associated with an exit or disposal activity of a business enterprise that commonly occur when there are redundant facilities or equipment, employee terminations due to reductions in business activities or other activities related to changes in business activities. Appropriate disclosure of any exit or disposal activity should be in the notes to the financial statements and the financial effects would be disclosed in the financial statements as required by FASB Statement No. 146.

Appendix A

Auditor's Standard Report

The following is an illustration of an auditor's report that expresses an unqualified opinion on the financial statements and on the supplementary schedules required by the Securities and Exchange Commission (SEC).

Independent Auditor's Report

Board of Directors
Standard Stockbrokerage Co., Inc.:

We have audited the accompanying [*consolidated*] statement of financial condition of Standard Stockbrokerage Co., Inc., [*and Subsidiaries*] (the Company) as of December 31, 20X6, and the related [*consolidated*] statements of income, changes in stockholders' equity, changes in liabilities subordinated to claims of general creditors, and cash flows for the year then ended that you are filing pursuant to rule 17a-5 under the Securities Exchange Act of 1934. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America.¹ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such*

¹ For audits conducted in accordance with PCAOB standards, PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*, replaces this sentence with the following sentence: "We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States)." On May 14, 2004, the SEC issued an interpretive release to help with the implementation of PCAOB Auditing Standard No. 1. See Release No. 33-8422 for more information. The release specifies that effective May 14, 2004, references in SEC rules and staff guidance and in the 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. The PCAOB, for example, has not established particular auditing standards for nonissuer broker-dealers or investment advisers. This release is not applicable to such engagements and related filings.

The staff of the PCAOB published a series of questions and answers ("Q&As") on PCAOB Auditing Standard No. 1. See the PCAOB Web site at www.pcaobus.org for more information.

In June 2004, the Auditing Standards Board ("ASB") issued Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report of a Nonissuer," in AU sec. 9508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), which provides reporting guidance for audits of nonissuers. Interpretation No. 18 in AU sec. 9508 provides guidance on the appropriate referencing of PCAOB auditing standards in audit reports when an auditor is engaged to perform the audit in accordance with both GAAS and PCAOB auditing standards. The ASB also is revising AU sec. 508 (AICPA, *Professional Standards*, vol. 1) in light of the International Auditing and Assurance Standards Board's recently exposed International Standard on Auditing, *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*, and PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the PCAOB*. See the AICPA Web site at www.aicpa.org/members/div/auditstd/index.htm for more information.

opinion.]² An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.³

In our opinion, the [*consolidated*] financial statements referred to above present fairly, in all material respects, the financial position of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] as of December 31, 20X6, and the results of its [*their*] operations and its [*their*] cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 under the Securities Exchange Act of 1934. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Accounting Firm
New York, New York
February 15, 20X7*

² This optional wording may be added in accordance with Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," in AU sec. 9508 (AICPA, *Professional Standards*, vol. 1), which was issued by the ASB in June 2004 and provides reporting guidance for audits of non-issuers. Interpretation No. 17 in AU sec. 9508 addresses how auditors may expand their independent audit report to explain that their consideration of internal control was sufficient to provide the auditor sufficient understanding to plan the audit and determine the nature, timing and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. If this optional language is added, then the remainder of the paragraph should read as follows:

"An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion."

³ See paragraphs 3.121 through 3.123 in Chapter 3 for information on obtaining confidential treatment of the financial statements from the SEC and Commodity Futures Trading Commission.

* In December 2005 the ASB issued SAS No. 103, *Audit Documentation*. SAS No. 103 supercedes SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339) and amends SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 530), "Dating of the Independent Auditor's Report." The amendment to SAS No. 1 changes the date of the auditor's report from the date of completion of fieldwork to require that the auditor's report be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. SAS No. 103 is effective for audits of financial statements for periods ending on or after December 15, 2006 with earlier application permitted.

Appendix B

Separate Report on Supplementary Schedules

It is also acceptable to present a separate auditor's report on the supplementary schedules as follows.

Independent Auditor's Report on Supplementary Information
Required by Rule 17a-5 of the Securities and Exchange Commission

Board of Directors
Standard Stockbrokerage Co., Inc.:

We have audited the accompanying [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] as of and for the year ended December 31, 20X6, and have issued our report thereon dated February 15, 20X7. Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 under the Securities Exchange Act of 1934. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Accounting Firm
New York, New York
February 15, 20X7

Appendix C

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

The following is an illustration of the independent auditor's report on internal control required by Securities Exchange Commission (SEC) rule 17a-5:

Board of Directors
Standard Stockbrokerage Co., Inc.:

In planning and performing our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company), for the year ended December 31, 20X5, we considered its internal control, including control activities for safeguarding securities, in order to determine our auditing procedures for the purpose of expressing our opinion on the [*consolidated*] financial statements and not to provide assurance on internal control.

Also, as required by rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company, including tests of compliance with such practices and procedures that we considered relevant to the objectives stated in rule 17a-5(g), in the following:

1. Making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under rule 17a-3(a)(11) and the reserve required by rule 15c3-3(e)
2. Making the quarterly securities examinations, counts, verifications, and comparisons, and the recordation of differences required by rule 17a-13
3. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System
4. Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by rule 15c3-3

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls, and of the practices and procedures referred to in the preceding paragraph, and to assess whether those practices and procedures can be expected to achieve the SEC's above-mentioned objectives. Two of the objectives of internal

* This report is based on guidance provided in SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 325). In May 2006, the ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, which supersedes SAS No. 60. SAS No. 112 is effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier implementation is permitted.

This report has not been modified to conform to guidance provided in SAS No. 112. If the auditor is issuing a report related to the audit of financial statements for periods ending on or after December 15, 2006, or chooses to implement SAS No. 112 early, please refer to Appendix C-1 which contains a report that has been modified to reflect the guidance provided in SAS No. 112.

control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control and the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate. Our consideration of internal control would not necessarily disclose all matters in internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving internal control, including control activities for safeguarding securities, that we consider to be material weaknesses as defined above.¹

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the SEC to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures were adequate at December 31, 20X5, to meet the SEC's objectives.²

This report is intended solely for the information and use of the Board of Directors, management, the SEC, [*Designated self-regulatory organization*], and other regulatory agencies that rely on rule 17a-5(g) under the Securities

¹ If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of the fifth paragraph of the report should be modified as follows:

However, we noted the following matters involving the [control environment, accounting system, control activities, or control activities for safeguarding securities] and its [their] operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the consolidated financial statements of Standard Stockbrokerage Co., Inc., for the year ended December 31, 20X4, and this report does not affect our report thereon dated February 15, 20X5. [A description of the material weaknesses that have come to the auditor's attention and corrective action.]

² Whenever inadequacies are described, the report should include the last sentence of the fifth paragraph as modified in the note above. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period, unless management already has reported them to the SEC.

Exchange Act of 1934 in their regulation of registered brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm
New York, New York
February 15, 20X6

Appendix C-1

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

The following is an illustration of the independent auditor's report on internal control required by CFTC Regulation 1.16 and SEC Rule 17a-5(g)(1).

Board of Directors
Standard Stockbrokerage Co., Inc.:

In planning and performing our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company), as of and for the year ended December 31, 20X6, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the [*consolidated*] financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Also, as required by rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company, including consideration of control activities for safeguarding securities. This study included tests of compliance with such practices and procedures that we considered relevant to the objectives stated in rule 17a-5(g), in the following:

1. Making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under rule 17a-3(a)(11) and the reserve required by rule 15c3-3(e)
2. Making the quarterly securities examinations, counts, verifications, and comparisons, and the recordation of differences required by rule 17a-13
3. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System
4. Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3.

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs

* This report is based on guidance provided in SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), which was issued in May 2006. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended (AU sec. 325). SAS No. 112 is effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier implementation is permitted.

If the auditor is issuing a report related to the audit of financial statements for periods ending before December 15, 2006, and chooses not to implement SAS No. 112 early, please refer to Appendix C which contains a report that has not been modified to reflect the guidance provided in SAS No. 112.

For audits conducted in accordance with PCAOB standards refer to footnote 1 in Appendix A.

of controls, and of the practices and procedures referred to in the preceding paragraph, and to assess whether those practices and procedures can be expected to achieve the SEC's above-mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control and the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first and second paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities that we consider to be material weaknesses, as defined above.¹

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the SEC to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study,

¹ If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of this paragraph of the report should be modified as follows:

However, we identified the following deficiencies in [internal control or control activities for safeguarding securities] that we consider to be material weaknesses, as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures performed in our audit of the [consolidated] financial statements of Standard Stockbrokerage Co., Inc. [and Subsidiaries] as of and for the year ended December 31, 20X6, and this report does not affect our report thereon dated February 15, 20X7. [A description of the material weaknesses that have come to the auditor's attention and corrective action.]

we believe that the Company's practices and procedures, as described in the second paragraph of this report, were adequate at December 31, 20X6, to meet the SEC's objectives.²

This report is intended solely for the information and use of the Board of Directors, management, the SEC, [*Designated self-regulatory organization*], and other regulatory agencies that rely on rule 17a-5(g) under the Securities Exchange Act of 1934 in their regulation of registered brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm
New York, New York
February 15, 20X7

² Whenever inadequacies are described, the last sentence of this paragraph should be modified as per note 1 above. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period, unless management already has reported them to the SEC.

Appendix D

Report on Internal Control Required by SEC Rule 17a-5 for a Broker-Dealer Claiming an Exemption From SEC Rule 15c3-3^{*},¹

The following is an illustration of an independent auditor's report on internal control of a broker-dealer claiming an exemption from Securities and Exchange Commission (SEC) rule 15c3-3.

Board of Directors
Standard Stockbrokerage Co., Inc.:

In planning and performing our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company), for the year ended December 31, 20X5, we considered its internal control, including control activities for safeguarding securities, in order to determine our auditing procedures for the purpose of expressing our opinion on the [*consolidated*] financial statements and not to provide assurance on internal control.

Also, as required by rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company including tests of such practices and procedures that we considered relevant to the objectives stated in rule 17a-5(g) in making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under rule 17a-3(a)(11) and for determining compliance with the exemptive provisions of rule 15c3-3. Because the Company does not carry securities accounts for customers or perform custodial functions relating to customer securities, we did not review the practices and procedures followed by the Company in any of the following:

1. Making quarterly securities examinations, counts, verifications, and comparisons and recordation of differences required by rule 17a-13
2. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls and of the practices and procedures referred to in the preceding

^{*} This report is based on guidance provided in SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 325). In May 2006, the ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, which supersedes SAS No. 60. SAS No. 112 is effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier implementation is permitted.

This report has not been modified to conform to guidance provided in SAS No. 112. If the auditor is issuing a report related to the audit of financial statements for periods ending on or after December 15, 2006, or chooses to implement SAS No. 112 early, please refer to Appendix D-1 which contains a report that has been modified to reflect the guidance provided in SAS No. 112.

¹ There are different types of exemptions under SEC Rule 15c3-3—k(1), k(2)(i), and k(2)(ii). Other formats of this letter will be required depending on the type of the exemption filed.

paragraph and to assess whether those practices and procedures can be expected to achieve the SEC's above-mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control and the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

Our consideration of internal control would not necessarily disclose all matters in internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving internal control, including control activities for safeguarding securities, that we consider to be material weaknesses as defined above.²

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the SEC to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures were adequate at December 31, 20X5, to meet the SEC's objectives.³

This report is intended solely for the information and use of the Board of Directors, management, the SEC, [*Designated self-regulatory organization*], and other regulatory agencies that rely on rule 17a-5(g) under the Securities

² If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of this paragraph of the report should be modified as follows:

However, we noted the following matters involving the [control environment, accounting system, control activities, or control activities for safeguarding securities] and its [their] operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures performed in our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*], as of and for the year ended December 31, 20X5, and this report does not affect our report thereon dated February 15, 20X6. [*A description of the material weaknesses that have come to the auditor's attention and corrective action.*]

³ Whenever inadequacies are described, the last sentence of this paragraph should be modified as per note 2 above. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period, unless management already has reported them to the SEC.

Exchange Act of 1934 in their regulation of registered brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm
New York, New York
February 15, 20X6

Appendix D-1

Report on Internal Control Required by SEC Rule 17a-5 for a Broker-Dealer Claiming an Exemption From SEC Rule 15c3-3¹

The following is an illustration of an independent auditor's report on internal control of a broker-dealer claiming an exemption from Securities and Exchange Commission (SEC) rule 15c3-3.

Board of Directors
Standard Stockbrokerage Co., Inc.:

In planning and performing our audit of the [consolidated] financial statements of Standard Stockbrokerage Co., Inc. [and Subsidiaries] (the Company), as of and for the year ended December 31, 20X6, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the [consolidated] financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Also, as required by rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company including consideration of control activities for safeguarding securities. This study included tests of such practices and procedures that we considered relevant to the objectives stated in rule 17a-5(g) in making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under rule 17a-3(a)(11) and for determining compliance with the exemptive provisions of rule 15c3-3. Because the Company does not carry securities accounts for customers or perform custodial functions relating to customer securities, we did not review the practices and procedures followed by the Company in any of the following:

1. Making quarterly securities examinations, counts, verifications, and comparisons and recordation of differences required by rule 17a-13
2. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System

* This report is based on guidance provided in SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), which was issued in May 2006. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended (AU sec. 325). SAS No. 112 is effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier implementation is permitted.

If the auditor is issuing a report related to the audit of financial statements for periods ending before December 15, 2006, and chooses not to implement SAS No. 112 early, please refer to Appendix D which contains a report that has not been modified to reflect the guidance provided in SAS No. 112.

For audits conducted in accordance with PCAOB standards refer to footnote 1 in Appendix A.

¹ There are different types of exemptions under SEC Rule 15c3-3—k(1), k(2)(i), and k(2)(ii). Other formats of this letter will be required depending on the type of the exemption filed.

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls and of the practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the SEC's above-mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control and the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first and second paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities that we consider to be material weaknesses, as defined above.²

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the SEC to be adequate for its purposes in accordance with the Securities Exchange

² If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of this paragraph of the report should be modified as follows:

However, we identified the following deficiencies in [internal control or control activities for safeguarding securities] that we consider to be material weaknesses, as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures performed in our audit of the [consolidated] financial statements of Standard Stockbrokerage Co., Inc. [and Subsidiaries] as of and for the year ended December 31, 20X6, and this report does not affect our report thereon dated February 15, 20X7. [A description of the material weaknesses that have come to the auditor's attention and corrective action.]

Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures, as described in the second paragraph of this report, were adequate at December 31, 20X6, to meet the SEC's objectives.³

This report is intended solely for the information and use of the Board of Directors, management, the SEC, [*Designated self-regulatory organization*], and other regulatory agencies that rely on rule 17a-5(g) under the Securities Exchange Act of 1934 in their regulation of registered brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm
New York, New York
February 15, 20X6

³ Whenever inadequacies are described, the last sentence of this paragraph should be modified as per note 2 above. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period, unless management already has reported them to the SEC.

Appendix E

Letter to SEC When the Broker-Dealer Has Not Made the Required Notification

The following report is appropriate if the broker-dealer has not made the required notification of material inadequacy or if the auditor does not agree with the statements therein. Modification of this letter may be required based on the facts and circumstances of the particular situation.

Securities and Exchange Commission
Washington D.C., and [Appropriate
regional office]
Designated Examining Authority

Dear Sirs:

Our most recent audit of the [consolidated] financial statements of Standard Stockbrokerage Co., Inc. [and Subsidiaries] (the Company), was as of December 31, 20X5, and for the year then ended, which we reported on under date of February 15, 20X6. We have not audited any financial statements of the Company as of any date or for any period subsequent to December 31, 20X5. Although we are presently performing certain procedures as part of our audit of the [consolidated] financial statements of the Company as of December 31, 20X6, and for the year then ending, these procedures do not constitute all the procedures necessary in an audit conducted in accordance with auditing standards generally accepted in the United States of America or all the procedures necessary to (1) consider the Company's internal control as required by generally accepted auditing standards or (2) study the Company's practices and procedures relevant to the objectives stated in rule 17a-5(g) of the Securities and Exchange Commission as required by rule 17a-5.

The management of the Company is responsible for establishing and maintaining internal control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls. The objectives of internal control are to provide management with reasonable but not absolute assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and are recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles.

Because of inherent limitations in internal control, error or fraud may occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the effectiveness of the design and operation of controls may deteriorate.

The purpose of performing certain procedures prior to the date of the financial statements is to facilitate the expression of an opinion on the Company's financial statements. It must be understood that the procedures performed would not necessarily identify all material weaknesses in internal control and control activities for safeguarding securities.

However, pursuant to the requirements of rule 17a-5(h)(2), we are to call to the attention of the chief financial officer any weaknesses that we believe to be material and that were disclosed during the course of interim work. We have made such notification to the chief financial officer of Standard Stockbrokerage Co., Inc., and we believe the following additional information is required pursuant to the requirements of the rule.

[List and describe all instances where the independent auditor did not agree with the notification of the broker or dealer or where the required notification was not made.]

Accounting Firm
New York, New York
December 10, 20X6

Appendix F

Report on Internal Control Required by CFTC Regulation 1.16 and SEC Rule 17a-5(g)(1)*

The following is an illustration of the independent auditor's report on internal control required by CFTC Regulation 1.16 and SEC Rule 17a-5(g)(1).

Board of Directors
Standard Stockbrokerage Co., Inc.:

In planning and performing our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company) for the year ended December 31, 20X5, we considered its internal control, including control activities for safeguarding securities and certain regulated commodity customer and firm assets, in order to determine our auditing procedures for the purpose of expressing our opinion on the [*consolidated*] financial statements and not to provide assurance on internal control.

Also, as required by Rule 17a 5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company, including tests of compliance with such practices and procedures that we considered relevant to the objectives stated in Rule 17a 5(g), in the following:

1. Making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under Rule 17a 3(a)(11) and the reserve required by Rule 15c3 3(e)
2. Making the quarterly securities examinations, counts, verifications, and comparisons, and the recordation of differences required by Rule 17a 13
3. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System
4. Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3 3.

In addition, as required by Regulation 1.16 of the Commodity Futures Trading Commission (CFTC), we have made a study of the practices and procedures followed by the Company including tests of such practices and procedures that we considered relevant to the objectives stated in Regulation 1.16, in making the following:

1. The periodic computations of minimum financial requirements pursuant to Regulation 1.17

* This report is based on guidance provided in SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended (AICPA, *Professional Standards*, vol. 1, AU sec. 325). In May 2006, the ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, which supersedes SAS No. 60. SAS No. 112 is effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier implementation is permitted.

This report has not been modified to conform to guidance provided in SAS No. 112. If the auditor is issuing a report related to the audit of financial statements for periods ending on or after December 15, 2006, or chooses to implement SAS No. 112 early, please refer to Appendix F-1 which contains a report that has been modified to reflect the guidance provided in SAS No. 112.

2. The daily computations of the segregation requirements of Section 4d(a)(2) of the Commodity Exchange Act and the regulations thereunder, and the segregation of funds based on such computations
3. The daily computations of the foreign futures and foreign options secured amount requirements pursuant to Regulation 30.7 of the CFTC.

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraphs. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls and of the practices and procedures referred to in the preceding paragraphs and to assess whether those practices and procedures can be expected to achieve the SEC's and the CFTC's above-mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a 5(g) and Regulation 1.16(d)(2) list additional objectives of the practices and procedures listed in the preceding paragraphs.

Because of inherent limitations in internal control and the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

Our consideration of internal control would not necessarily disclose all matters in internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving internal control, including control activities for safeguarding securities and certain regulated commodity customer and firm assets, that we consider to be material weaknesses, as defined above.¹

¹ If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of this paragraph of the report should be modified as follows:

However, we noted the following matters involving the [control environment, accounting system, control activities, or control activities for safeguarding securities and certain regulated commodity customer and firm assets] and its [their] operation that we consider to be material weaknesses, as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures performed in our audit of the [consolidated] financial statements of Standard Stockbrokerage Co., Inc. [and Subsidiaries] as of and for the year ended December 31, 20X5, and this report does not affect our report thereon dated February 15, 20X6. [A description of the material weaknesses that have come to the auditor's attention and corrective action.]

We understand that practices and procedures that accomplish the objectives referred to in the second and third paragraphs of this report are considered by the SEC and CFTC to be adequate for their purposes in accordance with the Securities Exchange Act of 1934, the Commodity Exchange Act, and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures were adequate at December 31, 20X5, to meet the SEC's and CFTC's objectives.²

This report is intended solely for the information and use of the Board of Directors, management, the SEC, the CFTC, [*Designated Self-Regulatory Organization*] and other regulatory agencies that rely on Rule 17a 5(g) under the Securities Exchange Act of 1934 and/or Regulation 1.16 of the CFTC in their regulation of registered broker-dealers and futures commission merchants, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm
New York, New York
February 15, 20X6

² Whenever inadequacies are described, the last sentence of this paragraph should be modified as per note 1 above. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period, unless management already has reported them to the SEC and the CFTC.

Appendix F-1

Report on Internal Control Required by CFTC Regulation 1.16 and SEC Rule 17a-5(g)(1)*

The following is an illustration of the independent auditor's report on internal control required by CFTC Regulation 1.16 and SEC Rule 17a-5(g)(1).

Board of Directors
Standard Stockbrokerage Co., Inc.:

In planning and performing our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company) as of and for the year ended December 31, 20X6, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the [*consolidated*] financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Also, as required by Rule 17a 5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company, including consideration of control activities for safeguarding securities. This study included tests of compliance with such practices and procedures that we considered relevant to the objectives stated in Rule 17a 5(g), in the following:

1. Making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under Rule 17a 3(a)(11) and the reserve required by Rule 15c3 3(e)
2. Making the quarterly securities examinations, counts, verifications, and comparisons, and the recordation of differences required by Rule 17a 13
3. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System
4. Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3 3.

In addition, as required by Regulation 1.16 of the Commodity Futures Trading Commission (CFTC), we have made a study of the practices and procedures followed by the Company including consideration of control activities for safeguarding customer and firm assets. This study included tests of such practices

* This report is based on guidance provided in SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), which was issued in May 2006. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended (AU sec. 325). SAS No. 112 is effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier implementation is permitted.

If the auditor is issuing a report related to the audit of financial statements for periods ending before December 15, 2006, and chooses not to implement SAS No. 112 early, please refer to Appendix F which contains a report that has not been modified to reflect the guidance provided in SAS No. 112.

For audits conducted in accordance with PCAOB standards refer to footnote 1 in Appendix A.

and procedures that we considered relevant to the objectives stated in Regulation 1.16, in making the following:

1. The periodic computations of minimum financial requirements pursuant to Regulation 1.17
2. The daily computations of the segregation requirements of Section 4d(a)(2) of the Commodity Exchange Act and the regulations thereunder, and the segregation of funds based on such computations
3. The daily computations of the foreign futures and foreign options secured amount requirements pursuant to Regulation 30.7 of the CFTC.

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraphs. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls and of the practices and procedures referred to in the preceding paragraphs and to assess whether those practices and procedures can be expected to achieve the SEC's and the CFTC's above-mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a 5(g) and Regulation 1.16(d)(2) list additional objectives of the practices and procedures listed in the preceding paragraphs.

Because of inherent limitations in internal control and the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first, second and third paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for

safeguarding securities and certain regulated commodity customer and firm assets that we consider to be material weaknesses, as defined above.¹

We understand that practices and procedures that accomplish the objectives referred to in the second and third paragraphs of this report are considered by the SEC and CFTC to be adequate for their purposes in accordance with the Securities Exchange Act of 1934, the Commodity Exchange Act, and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures, as described in the second and third paragraphs of this report, were adequate at December 31, 20X6, to meet the SEC's and CFTC's objectives.²

This report is intended solely for the information and use of the Board of Directors, management, the SEC, the CFTC, [*Designated Self-Regulatory Organization*] and other regulatory agencies that rely on Rule 17a 5(g) under the Securities Exchange Act of 1934 and/or Regulation 1.16 of the CFTC in their regulation of registered broker-dealers and futures commission merchants, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm
New York, New York
February 15, 20X6

¹ If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of this paragraph of the report should be modified as follows:

However, we identified the following deficiencies in [internal control or control activities for safeguarding securities and certain regulated commodity customer and firm assets] that we consider to be material weaknesses, as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures performed in our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] as of and for the year ended December 31, 20X6, and this report does not affect our report thereon dated February 15, 20X7. [*A description of the material weaknesses that have come to the auditor's attention and corrective action.*]

² Whenever inadequacies are described, the last sentence of this paragraph should be modified as per note 1 above. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period, unless management already has reported them to the SEC and the CFTC.

Appendix G

Representation Letter

[Date]

To [Independent Auditor]

We are providing this letter in connection with your audit of the consolidated statement of financial condition and the related consolidated statements of income, changes in stockholders' equity, changes in liabilities subordinated to claims of general creditors, and cash flows of Standard Stock Brokerage Co., Inc. and Subsidiaries (the Company) as of December 31, 20X6,¹ and for the year then ended, for the purpose of expressing an opinion as to whether the consolidated financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the Company in conformity with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation in the consolidated financial statements of financial condition, results of operations, and cash flows in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief [*as of (date of auditor's report)*], the following representations made to you during your audit.

1. The consolidated financial statements referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America and include all disclosures necessary for such fair presentation otherwise required to be included by the laws and regulations to which the Company is subject.
2. We have made available to you all—
 - a. Financial records and related data.
 - b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. The most recent meetings held were: [*state by group and date*]
3. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
4. There are no material transactions that have not been properly recorded in the accounting records underlying the consolidated financial statements.

¹ Note that AU sec. 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1; AICPA, *PCAOB Standards and Related Rules*), requires the auditor to obtain written representations from management for all financial statements and periods covered by the auditor's report.

5. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the consolidated financial statements taken as a whole.²
6. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
7. We have no knowledge of any fraud or suspected fraud affecting the Company involving—
 - a. Management,
 - b. Employees who have significant roles in internal control, or
 - c. Others where the fraud could have a material effect on the consolidated financial statements.
8. We have no knowledge of any allegations of fraud or suspected fraud affecting the Company received in communications from employees, former employees, analysts, regulators, short sellers, or others.
9. The Company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
10. The following have been properly recorded or disclosed in the consolidated financial statements:
 - a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
 - b. Guarantees, whether written or oral, under which the Company is contingently liable.
 - c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. [*Significant estimates are estimates at the statement of financial condition date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.*]
 - d. Arrangements with financial institutions involving compensating balance arrangements involving restrictions on cash balances and lines of credit, or similar arrangements.
 - e. The following information about financial instruments with off-balance-sheet risk and financial instruments [including receivables] with concentrations of credit risk:

² If management believes that certain of the identified items are not misstatements, management's belief may be acknowledged by adding to the representation, for example, "We do not agree that items XX and XX constitute misstatements because [description of reasons here]." Also, a summary of the uncorrected misstatements should be included in or attached to the representation letter.

- (1) The extent, nature, and terms of financial instruments with off-balance-sheet risk.
 - (2) The amount of credit risk of financial instruments with off-balance-sheet risk and information about the collateral supporting such financial instruments.
 - (3) Significant concentrations of credit risk arising from all financial instruments and information about the collateral supporting such financial instruments.
- f. Agreements to repurchase assets previously sold or resell assets previously purchased.
11. There are no—
- a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the consolidated financial statements or as a basis for recording a loss contingency.
 - b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.³
 - c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
12. The Company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral, except as disclosure in the consolidated financial statements.
13. The Company has complied with all aspects of contractual agreements that would have a material effect on the consolidated financial statements in the event of noncompliance.
14. Customers' debit balances, brokers' debit balances, and other accounts receivable are valid receivables. In our opinion, an adequate reserve has been established to cover any losses that may be incurred upon collection.
15. Provision has been made for any material loss to be sustained in the fulfillment of or from the inability to fulfill any purchase or sales commitments.
16. There are no securities or investments not readily marketable owned by the Company or borrowed under subordination agreements except as disclosed in the consolidated financial statements or notes thereto or as follows.

³ In the circumstance discussed in footnote 11 of AU sec. 333, this representation might be worded as follows:

We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the consolidated financial statements in accordance with Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

It is understood that the term "securities and investments not readily marketable" includes but is not limited to the following:

- a. Securities for which there is no market on a securities exchange or independent publicly quoted market.
 - b. Securities that cannot be publicly offered or sold unless registration has been effected under the Securities Act of 1933 (or the conditions of an exemption such as Regulation A under Section 3(B) of such act have been complied with), that is, restricted stock.
 - c. Securities and investments that cannot be offered or sold because of other arrangements, restrictions, or conditions applicable to the securities and investments or to the Company (that is, control stock).
17. The methods and significant assumptions used to determine fair values of financial instruments, including derivative product transactions, are as follows: *[Describe methods and significant assumptions used to determine fair value appropriate for financial statement measurement and disclosure purposes.]*
18. In addition, the Company at December 31, 20X6, had—
- a. Recorded all securities exchange memberships on the books.
 - b. Properly recorded all participation in joint accounts carried by others.
 - c. No material unrecorded assets or contingent assets, such as claims relating to buy-ins, unfulfilled contracts, and so forth, whose value depends on the fulfillment of conditions regarded as uncertain.
 - d. No open contractual commitments other than those appearing on the memo books and records; for example, when-distributed and delayed delivery contracts, underwritings and when-issued contracts, endorsements or puts and calls, and commitments in foreign currencies and spot (cash) commodity contracts.
 - e. Established a reserve for dividends and transfer items and security differences that is adequate to cover any anticipated losses in connection with the short securities that may have to be covered or claims arising from the liquidation of long securities.
 - f. No borrowings or claims unconditionally subordinated to all claims or general creditors pursuant to a written agreement except as disclosed in the consolidated financial statements or notes thereto.
19. All liabilities subordinated to the claims of general creditors are covered by satisfactory subordination agreements under rule 15c3-1 and approved by *[Examining authority]*.
20. Note X to the consolidated financial statements discloses all of the facts (meaning, significant conditions and events and management plans) of which we are aware that are relevant to the Company's ability to continue as a going concern.

21. Risks associated with concentrations, based on information known to management, that meet all of the following criteria have been disclosed in the consolidated financial statements:
 - a. The concentration exists at the date of the consolidated financial statements.
 - b. The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.
 - c. It is the least reasonably possible that the events that could cause the severe impact with occur in the near term.
22. There are no capital withdrawals anticipated within the next six months other than as disclosed in the consolidated financial statements or notes thereto except as follows [*list any such items*].
23. There are no material weaknesses or inadequacies at December 31, 20X6, or during the period January 1, 20X6, to February 15, 20X7, in internal control and control activities for safeguarding securities, and the practices and procedures followed in*
 - a. Making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under rule 17a-3(a)(11) and the reserve required by rule 15c3-3(e).
 - b. Making the quarterly securities examinations, counts, verifications and comparisons, and the reconciliation of differences required by rule 17a-13.
 - c. Complying with the requirement for prompt payment for securities under Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System.
 - d. Obtaining and maintaining physical possession or control of all fully paid and excess-margin securities of customers as required by rule 15c3-3.
 - e. Making periodic computations of the minimum financial requirements pursuant to Regulation 1.17 of the Commodity Exchange Act.
 - f. Making daily computations of the segregation requirements of Section 4d(2) (and Regulation 30) of the Commodity Exchange Act and the regulations thereunder, and the segregation of funds based upon such computations.
24. Net capital computations, prepared by the Company during the period from January 1, 20X6, through February 15, 20X7, indicated that the Company was in compliance with the requirements of rule 15c3-1 (and applicable exchange requirements) at all times during

* The following representation should be utilized if the auditor has implemented SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, which supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*:

There are no significant deficiencies or material weaknesses or material inadequacies at December 31, 20X6, or during the period from January 1, 20X6 to February 15, 20X7, in internal control over financial reporting and control activities for safeguarding securities, and the practices and procedures followed in . . .

Refer to paragraphs 5.101–5.103 for more information.

the period. Reserve calculations under rule 15c3-3 during the period did not reveal any deposit requirements that were not made on a timely basis.

25. There was no computation of segregation requirements under the Commodity Exchange Act that indicated an insufficiency in segregation during the period from January 1, 20X6 through February 15, 20X7.
26. The Company has appropriately reconciled its books and records (e.g., general ledger accounts) underlying the consolidated financial statements to their related supporting information (e.g., sub ledger or third-party data). All related reconciling items considered to be material were identified and included on the reconciliations and were appropriately adjusted in the consolidated financial statements. There were no material unreconciled differences or general ledger suspense account items that should have been adjusted or reclassified to another account. All consolidating entries have been properly recorded. All intracompany and intercompany accounts have been eliminated or appropriately measured and considered for disclosure in the consolidated financial statements.
27. Foreign and domestic operating subsidiaries of the Company which are subject to local securities and capital adequacy requirements were in compliance with such regulations and requirements at December 31, 20X6 and for the year then ended.
28. All borrowings and financial obligations of the Company of which we are aware are included in the consolidated financial statements at December 31, 20X6 as appropriate. We have fully disclosed to you all borrowing arrangements of which we are aware.

To the best of our knowledge and belief, no events have occurred subsequent to the statement of financial condition date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

[Name of Chief Executive Officer and Title]

[Name of Chief Financial Officer and Title]

For publicly-held broker dealers that include certifications of the Chief Executive Officer and Chief Financial Officer when filing with the SEC, the individuals certifying in those capacities should also sign the representation letter in order to directly confirm and document the communications to auditors described in their certifications (see paragraphs 5.110 and 5.111). Other officers who provide material representations during the audit should also be considered for inclusion as signers.

Appendix H

Agreed-Upon Procedures

[Date]

To the Board of Directors
Standard Stockbrokerage Co., Inc.:

We have performed the procedures enumerated below, which were agreed to by the Standard Stockbrokerage Co., Inc. (the Company) and [Name of government sponsored entity] (the Agency), solely to assist the specified parties in evaluating the Company's compliance with Section(s) of the Agency's Selling Group Agreement dated [Date] (the Agreement), entitled [Title], and Section(s) entitled [Title] of the Guidelines to the Agreement (collectively, the Agreements and Procedures), during the period [Define period] (the Period). Management is responsible for the Company's compliance with those requirements. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report was requested or for any other purpose.

The procedures we have performed are as follows.

1. Read the Agreement(s) and Procedure(s).
2. Obtained written representation from management of the Company stating that: (1) the Company complied with the provisions of the Agreement(s) and Procedure(s) for the Period; (2) all records maintained pursuant to the Agreement(s) are retained in accordance with the record-keeping provisions of the Agreement(s) and Procedure(s); (3) all required offering documentation had been sent to investors during the Period in accordance with the Agreement(s); and (4) for any affiliates, domestic or foreign, through which primary [Agency] securities were distributed to customers, the compliance standards maintained were also met by the affiliates; additionally, any affiliates not meeting such standards were excluded from participating in primary distribution of [Agency] securities.
3. Read the Company's trading and selling policies and procedures related to the Agreements noted above as furnished to us by the Company. *[If policies and procedures are not documented in writing, the accountant should so indicate.]*
4. Based on our reading of the above-mentioned trading and selling policies and procedures, noted that the traders and salespeople (including salespeople in domestic and foreign affiliates which operate as broker/dealers for Agency primary issuance) involved in the offering and sale of Agency Securities are required to read and be familiar with the Agreement(s) and the Company's written procedures covering the offering and sale of Agency Securities.
5. Inquired of the designated individuals within the Company responsible for monitoring compliance with the Agreement(s) and Procedure(s) as to whether there are any written reports prepared during

the Period relative to the Company's compliance with the Agreement(s) and Procedure(s).

6. Obtained and read the report(s) noted in step 5 above (if applicable) and have confirmed that the reports did not contain any findings that would be deemed to be in non-compliance with the Agreement(s) and Procedure(s).
7. Obtained from the Company a list of all issues and the total allotment for which the Company has acted as a selling group member during the Period (see Appendix I, "Agency Issues Participation Listing"). The Company has represented to us that such list is complete and accurate. The listings were compared to the detail supplied by the Agency. Please note that certain agencies, for example, the Federal National Mortgage Association (FNMA or Fannie Mae) may provide the independent auditor with this list. When provided, this list should be utilized in performing all related procedures.
8. Requested and obtained the Distribution Reports, Bond Market Association (BMA)¹ Prepricing Reports or substantially similar reports that include all the information that is contained in a BMA Prepricing Report (Prepricing Reports), trade tickets, and general ledger account detail from Company personnel for a sample of issues [*state number of issues*] referred to in step 7 above. Please note the following:
 - a. All other relevant trading account records will be requested and report names and terminology may vary.
 - b. The Company should confer with each Agency to determine the appropriate number of issues for selection purposes.
 - c. Certain agencies will provide the independent auditor with copies of Distribution Reports (for example, Fannie Mae). In these instances, the reports and the complete list of issues (described in step 7 above) received from the Agency should be used to perform this step.
9. Performed the following procedures with respect to the Distribution Reports for issues selected in step 8 above.
 - a. Read the Distribution Reports and noted signatures; Company representatives indicated that individuals who signed the Distribution Reports were authorized persons pursuant to Section [*Number*] of the Agreement.
 - b. Compared and agreed the number of transactions, amount, and classification [*Municipal organization, corporation, brokers, etc.*] of all sales to customers, before when-issued trading, and total allotment from the Distribution Reports to the Prepricing Reports.
 - c. Recomputed the mathematical accuracy of all totals on the Distribution Reports.

¹ The Bond Market Association was formerly the Public Securities Association.

10. Performed the following procedures with respect to the Prepricing Reports for issues as obtained in step 8.
 - a. Selected haphazardly [*Number*] orders for each sample issue selected in step 8.
 - b. For all orders selected in step a above, verified information accuracy by utilizing internal records or sent confirmation requests to confirm the amount, price, type of order, type of customer, trade date and other specified conditions of the order (for example, limit order). All orders selected must be validated via the described procedures or alternative procedures. Less than 100% compliance should be noted as an exception. [Please note that the number and minimum confirm response rate should be determined by the Company in conjunction with the Agency.] Confirmation results should be summarized and the nature of exceptions, if any, should be described either in the body of the report or in a separate attachment. See Appendix J, "Confirmation Statistics," for a summary of confirmations.
 - c. For all orders selected in step 10a above, compared and agreed individual orders and amounts to the related trade tickets and general ledger account detail.
 - d. Read each Prepricing Report for the applicable issues identified in step 8 above, noting that total allotment and order conditionality were noted on such Report.
 - e. For all orders selected in step 10a above, read the trade tickets, noting that the sales prices were at face value or at prices offered to the public as published by the Agency.
 - f. For [*Number*] transactions haphazardly selected from the Prepricing Reports obtained in step 8 above, we obtained from representatives of the Company the names of the sales person(s) (institutional or retail) who were involved in the transactions, and obtained documentation as provided by the Company indicating that such individuals have received training, as defined in the Agreement(s). Such documentation consists of [*Describe*].
11. [*For purchases and sales from or to other members of the Agency Bond Selling Group (Reallowance Orders), if any, prior to the time that the securities are free to trade on the offering date, the Company is required to receive express authorization or specific permission from the Agency for such purchases and sales from the Agency for Reallowance Orders for such issue. Please note that authorization is not required for all reallowance orders. Certain reallowance orders are permitted under the Agreement. The Company should read the Agreement and contact the Agency for purposes of identifying such orders.*] Attached is a list in Appendix K, "List of Reallowance Orders," of all reallowance orders for which authorization is required as represented to us by the Company.

12. *[For all orders for the account of an affiliate of the Company or for another nonaffiliated dealer who is not a member of the Agency Selling Group that are purchasing the securities, the Company must specifically advise the Agency of such orders.]* Compared the principal amount and trade date for such purchases as provided to us by representatives of the Company from the trade tickets to the corresponding data reflected in the notification to the Agency as provided by the Company, and found them to be in agreement.
13. For all participating programs, reviewed the Company's policies and procedures relative to the process of identifying, initiating, tracking, recording and sending of the required offering documentation. For the items selected above, ensured the customers received offering documentation (as an alternative procedure, customer confirmations can be sent). Any exceptions should be provided in an attachment.

We were not engaged to, and did not conduct an examination, the objective of which would be the expression of an opinion on compliance. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of Standard Stockbrokerage Co., Inc. and *[Name of specified government sponsored entity using the report]* and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm
New York, New York
May 15, 20X7

Note: The agreed-upon procedures report suggests certain procedures that the independent auditor should perform. Please note the Company may request its independent auditor to perform other procedures. Such additional procedures should be performed to satisfy other specific requirements of certain government agencies and the Company should consult with the agencies in determining such procedures.

Appendix J

Standard Stockbrokerage Co., Inc.
Confirmation Statistics¹
[March 15, 20X7] Offering

<i>Confirmations—Orders²</i>		
Total number of orders	[#]	\$[Amount]
Orders confirmed	[#]	\$[Amount]
Confirmations returned without exception	[#]	\$[Amount]
Confirmations returned with exception	[#]	\$[Amount]
Confirmation exceptions cleared	[#]	\$[Amount]
Alternative procedures performed	[#]	\$[Amount]
Coverage ³ (based on number of confirmations mailed)	[%]	

[April 30, 20X7] Offering

<i>Confirmations—Orders²</i>		
Total number of orders	[#]	\$[Amount]
Orders confirmed	[#]	\$[Amount]
Confirmations returned without exception	[#]	\$[Amount]
Confirmations returned with exception	[#]	\$[Amount]
Confirmation exceptions cleared	[#]	\$[Amount]
Alternative procedures performed	[#]	\$[Amount]
Coverage ³ (based on number of confirmations mailed)	[%]	

¹ Certain agencies may incorporate the contents of this Appendix into the agreed-upon procedures report.

² Orders include filled, partially filled, not filled or canceled orders.

³ If the minimum response rate is not obtained as determined in Step 10a of the report, two follow-up requests, either written or oral, should be performed. Further, if the minimum response rate is not obtained through follow-up requests, alternative procedures should be performed and described in the body of the report or in a separate attachment.

Appendix K**Standard Stockbrokerage Co., Inc.****List of Reallowance Orders¹*****[March 15, 20X7] Offering***

<u><i>Date</i></u>	<u><i>Description of Security</i></u>	<u><i>Quantity Re-allowed</i></u>	<u><i>Purchase Amount</i></u>	<u><i>Sell Amount</i></u>
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[April 30, 20X7] Offering

<u><i>Date</i></u>	<u><i>Description of Security</i></u>	<u><i>Quantity Re-allowed</i></u>	<u><i>Purchase Amount</i></u>	<u><i>Sell Amount</i></u>
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¹ Certain agencies may incorporate the contents of this appendix into the agreed-upon procedures report.

Appendix L

Auditor's Standard Report on Consolidated Supervised Entity

The following is an illustration of the report of the independent registered public accounting firm that expresses unqualified opinions on the financial statements of the consolidated supervised entity (CSE), management's assessment of the effectiveness of CSE's internal control over financial reporting, the effectiveness of CSE's internal control over financial reporting, and on the supplementary schedule of capital and allowances required by SEC Rule 15c-1 Appendix G under the Securities Exchange Act of 1934.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of ABC Company:

We have audited the accompanying consolidated balance sheets of ABC Company and subsidiaries ("ABC Company") as of December 31, 20XX and December 31, 20XY, and the related consolidated statements of income, changes in stockholders' equity, comprehensive income and cash flows for each of the three years in the period ended December 31, 20XX. These financial statements are the responsibility of ABC Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of ABC Company as of December 31, 20XX and December 31, 20XY, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20XX, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of ABC Company's internal control over financial reporting as of December 31, 20XX, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February XX, 20XZ expressed an unqualified opinion on management's assessment of the effectiveness of ABC Company's internal control over financial reporting and an unqualified opinion on the effectiveness of ABC Company's internal control over financial reporting.

Our audit was conducted for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The consolidated statement of capital and allowances as of December 31, 20XX is presented for the purpose of additional analysis and is not a required part of the basic consolidated

financial statements, but is supplementary information required by Rule 15c-1 Appendix G under the Securities Exchange Act of 1934. This schedule is the responsibility of the Company's management. Such schedule has been subjected to the auditing procedures applied in our audit of the basic consolidated financial statements and, in our opinion, is fairly stated in all material respects when considered in relation to the basic financial statements taken as a whole.

Accounting Firm
New York, New York
February 15, 20X7

Appendix M

Separate Report on the Supplementary Schedule of Consolidated Supervised Entity

It is also acceptable to present a separate auditor's report on the supplementary schedule of capital and allowances of the consolidated supervised entity (CSE). It can be done using a redacted version of the CSE's annual report which excludes all marketing material and the MD (it is the financial statements only). Included below are a cover for the report, an index, a report on the schedule of capital and allowances, and a sample schedule of capital and allowances.

ABC Company

CONSOLIDATED FINANCIAL STATEMENTS
AND
SUPPLEMENTAL SCHEDULE
FOR THE YEAR ENDED DECEMBER 31, 20XX
AND INDEPENDENT AUDITORS' REPORT

This report is being filed in accordance with
Rule 15c3-1(g) under the Securities Exchange Act of 1934.
Confidential treatment is requested under the
Freedom of Information Act ("FOIA") in accordance with 17 C.F.R. 200.83.

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Pages 1 ~ XX have intentionally been omitted.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of ABC Company:

We have audited the accompanying consolidated financial statements of ABC Company and Subsidiaries as of and for the year ended December 31, 20XX, and have issued our report thereon dated February XX, 20XX. Our audit was conducted for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. The consolidated statement of capital and allowances as of December 31, 20XX is presented for the purpose of additional analysis and is not a required part of the basic consolidated financial statements, but is supplementary information required by Rule 15c-1 Appendix G under the Securities Exchange Act of 1934. This schedule is the responsibility of the Company's management. Such schedule has been subjected to the auditing procedures applied in our audit of the basic consolidated financial statements and, in our opinion, is fairly stated in all material respects when considered in relation to the basic consolidated financial statements taken as a whole.

Independent Registered Public Accounting Firm

New York, New York

February XX, 20XZ

ABC Company
Consolidated Statement of Capital and Allowances
(in millions)

<u>Allowable Capital</u>	December 31, 20XX
Common stockholders' equity	XX,XXX
Preferred stock	X,XXX
Trust preferreds	X,XXX
Subtotal	XX,XXX
Less: Goodwill	
Less: Deferred tax assets	XXX
Subtotal	XX,XXX
Qualifying long-term debt	XX,XXX
Qualifying subordinated debt	XX
Allowances for losses on loans, leases and commitments	XX
Total Allowable Capital	XX,XXX
Allowance for Credit Risk	XX,XXX
Allowance for Market Risk	XX,XXX
Allowance for Operational Risk	X,XXX
Total Allowances	XX,XXX

<u>Allowable Capital</u>	<u>December 31, 20XX</u>
Allowable Capital in Excess of Allowances	<u>XX,XXX</u>
Risk Weighted Assets	<u>XX,XXX</u>
Total Capital Ratio	<u>XX.XX%</u>

There are no material reconciling items between the amounts presented above and the XXX amounts reported in ABC Company's unaudited CSE filing as of December 31, 20XX. Therefore, no reconciliation of the two computations is deemed necessary.

CONFIDENTIAL TREATMENT REQUESTED BY ABC Company UNDER FOIA

Appendix N

Background Information, Discussion of Conclusions, and Comments Received

N.1 This appendix provides background information and discusses significant changes proposed in the exposure draft that preceded this Audit and Accounting Guide (Guide), the comments received on those proposed changes, and the conclusions that the American Institute of Certified Public Accountants (AICPA) Stockbrokerage and Investment Banking Committee (the Committee) reached on those proposed changes.

Background Information

N.2 This Guide was developed to assist accounting practitioners and auditors in preparing and auditing the financial statements of broker-dealers. It supersedes *Audits of Brokers and Dealers in Securities*, the Guide originally issued by the AICPA in 1985. It incorporates, to the latest date practicable, accounting and financial reporting requirements issued by the Financial Accounting Standards Board (FASB) and the AICPA Accounting Standards Executive Committee (AcSEC) and auditing standards issued by the AICPA Auditing Standards Board (ASB).

N.3 This Guide does not address the general application of those standards; rather, it focuses on special matters unique to preparing, auditing, and reporting on the financial statements of broker-dealers. AcSEC and the ASB found the Guide to be consistent with existing standards and principles covered by Rules 202, "Compliance With Standards," and 203, "Accounting Principles," of the AICPA *Code of Professional Conduct*.

Discussion of Conclusions and Comments Received

N.4 In August 1994, an exposure draft of a proposed Audit and Accounting Guide *Brokers and Dealers in Securities* was issued for public comment. Significant issues addressed by commentators are discussed below.

Subordinated Liabilities and Stockholders' Equity

N.5 The Guide does not permit reporting combined subordinated liabilities (those qualifying as capital in computing net capital requirements) with stockholders' equity in statements of financial condition, which was acceptable under the superseded Guide, while recognizing that such liabilities qualify as a component in computing broker-dealers' net capital requirements.

N.6 The Committee proposed this change because it believes that it is misleading to link those items together under the same heading and show a total for them. Such a presentation implies that subordinated liabilities are a component of stockholders' equity, unencumbered by the right of the creditor to be repaid. Liabilities frequently have repayment limitations of one sort or another, but nevertheless remain liabilities.

N.7 The superseded Guide justified the practice of combining subordinated liabilities and stockholders' equity on the grounds of the unique

regulatory aspects of subordinated liabilities and because the practice had been widespread, generally accepted, and well understood in the industry.

N.8 As to the unique regulatory requirements of such subordinated liabilities (limiting repayments that would impair the meeting of statutory net capital requirements), the Committee observes that other entities are required to meet regulatory capital requirements but do not present their financial statements based on such requirements.

N.9 In addition, the Committee believes that, as business activities of financial service entities become more homogeneous, it will benefit financial statement users if financial reporting anomalies among such entities can be reduced or eliminated.

N.10 No comments were received on this change, which the Committee supports.

Combined Financial Instruments

N.11 The exposure draft proposed using a combined value for financial instruments that are identified as components of an arbitrage trading strategy rather than separately valuing each financial instrument. It proposed that in valuing combined financial instruments, the effects of contract interest rate differences from current replacement rates and contractual cash flow versus the redemption value of the underlying security should be considered.

N.12 The transmittal letter accompanying the exposure draft asked for specific comments on the proposed accounting for combined financial instruments. Although no comment letter objected to the basic approach proposed, several did make suggestions and raised issues that were considered by the Committee. The Committee addressed those suggestions, which included how to—

- Identify financial instruments qualifying as components of a combined financial instrument.
- Amortize related revenue.
- Determine if management's intent is to hold a combined financial instrument to maturity is terminated.

Subsequently, new issues arose as to how to make guidance specific so that diversity in practice would not result from it. After lengthy consideration, the Committee decided to delete this topic from the Guide rather than delay publication.

N.13 The Committee notes that the staff of the Securities and Exchange Commission (SEC) Division of Market Regulation objects to the concept of combined financial instruments. The SEC staff will not accept the proposed valuation of a combined financial instrument to compute statutory net capital (the components of the combined financial instruments would have to be reported and valued separately). The SEC staff believes that the guidance proposed in the exposure draft is too subjective. In addition, the SEC presently intends to issue a concepts release that might affect how a combined financial instrument could be accounted for. Although the Committee recognizes that items are frequently treated differently for generally accepted accounting principles (GAAP) and regulatory purposes, it would like to avoid exacerbating such differences.

Delayed Delivery

N.14 This Guide changes how proprietary transactions for the delayed delivery of securities (delayed delivery trades) should be reported in financial statements.

N.15 Delayed delivery of securities occurs if the settlement date for a transaction is later than the date would have been were it to be settled in the regular way.

N.16 Transactions settled in the regular way are settled on or before a date established by convention or by regulations of the market in which the transaction is executed. (Regular-way trades on the New York Stock Exchange must settle within three business days.)

N.17 The 1985 Guide required that delayed-delivery trades be reflected in the statement of condition on the trade date, that is, accounted for the same way as regular-way trades. This Guide requires that delayed-delivery trades be reflected in the statement of condition on the settlement date with related gains or losses in value between the trade and settlement dates reported in income.

N.18 The change was made because delayed-delivery trades are executory contracts that may extend for significant periods of time and that, consequently, involve greater risk of nonperformance than regular-way trades. Conversely, when the previous Guide was issued, the delivery delay for most transactions was shorter than it is now. The Committee notes that the change brings accounting for such items into agreement with accounting for forward transactions to which delayed deliveries are similar.

N.19 Commentators objected to the change; only one of them stated a reason. That commentator stated that there is a diversity in practice among industries regarding accounting for delayed-delivery transactions, particularly among banks with broker-dealer subsidiaries. This person believes that the issue should be deliberated by the FASB so that due process, including determination of the impact and implications of changing the accounting, can be accomplished prior to implementation and an appropriate effective date can be established. Accordingly, this commentator does not support changing the accounting at this time.

N.20 The Committee acknowledges that there may be diversity in practice across industries. It realizes that the accounting recommended for broker-dealers may be applied by analogy to similar transactions in other industries. It believes that narrowing diversity for similar transactions across industries would be beneficial.

N.21 The Committee notes that whatever accounting is recommended in the final Guide will be Level B GAAP. The only way to comply with the commentators' recommendation would be to remove the guidance from the Guide, thus promoting rather than narrowing diversity in practice. The Committee believes that the accounting change has had sufficient due process but, because it may have a wider effect than was contemplated, will allow a sufficient implementation period and not require the retroactive restatement of financial statements.

Other Comments

N.22 In addition to comments on the issue of combined financial instruments, commentators suggested numerous editorial revisions. Most of those recommended that descriptive items be added, expanded, or revised. The Committee implemented suggestions that it believes enhance the Guide without adding nonessential details.

Appendix O

Information Sources

Further information on matters addressed in this Guide is available through various publications and services listed in the table that follows. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

Information Sources

Organization	General Information	Fax	Web Site Address/ Electronic Bulletin Board	Recorded Announcements
American Institute of Certified Public Accountants	<i>Order Department</i> Harborside Financial Center, 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077 If outside of the U.S., call (201) 938-3000	24 Hour Fax Hotline (800) 362-5066	www.aicpa.org	
Financial Accounting Standards Board	<i>Order Department</i> 401 Merrit 7, P O Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		www.fasb.org	
U.S. Securities and Exchange Commission	100 F Street, NE Washington, DC 20549 <i>Publications Unit</i> (202) 551-4040 <i>SEC Public Reference Room</i> (202) 551-8090		www.sec.gov	<i>Information Line</i> (202) 942-8088
Securities Industry Association	120 Broadway New York, NY 10271-0080 (212) 608-1500	(212) 968-0703	www.sia.com	
New York Stock Exchange, Inc.	Eleven Wall Street New York, NY 10005 (212) 656-3000		www.nyse.com	

<p>National Association of Securities Dealers, Inc.</p>	<p>1735 K Street, NW Washington, DC 20007-1501 (01) 590-6500</p>		<p>www.nasd.com</p>	
<p>The Bond Market Association)</p>	<p>360 Madison Avenue New York, NY 10001</p>	<p>(646) 637-9067</p>	<p>www.bondmarkets.com</p>	
<p>Commodity Futures Trading Commission</p>	<p>Three Lafayette Center 1155 21st Street, NW Washington, DC 20581 (202) 418-5430 (Div. of Trading & Markets)</p>	<p>(202) 418-5000</p>	<p>www.cftc.gov</p>	
<p>Futures Industry Association</p>	<p>2001 Pennsylvania Avenue, NW Suite 600 Washington, DC 20006-1807 (202) 466-5460</p>	<p>(202) 296-3184</p>	<p>www.futuresindustry.org</p>	
<p>National Futures Association</p>	<p>200 West Madison Street Suite 1600 Chicago, IL 60606-3447 <i>Information Center</i> (312) 781-1300</p>	<p>(312) 781-1467</p>	<p>www.nfa.futures.org</p>	

Appendix P

Schedule of Changes Made to Brokers and Dealers in Securities

As of May 2006

All schedules of changes reflect only current year.

Reference	Change
General	Deleted referencing to the originally issued Statement on Auditing Standards (SAS), Statement on Standards for Attestation Engagements (SSAE) and PCAOB Auditing Standards; Modified AICPA <i>Professional Standards</i> presentation.
Notice to Readers	<ul style="list-style-type: none"> —Revised footnote * about FASB project on GAAP hierarchy to reflect the current status of this project. —Revised the paragraph preceding the "Public Accounting Firms Registered with the PCAOB" section to reflect guidance of SAS No. 102, <i>Defining Professional Requirements in Statements on Auditing Standards</i>. —Revised the list of standards through which the guide was updated to reflect the most current authoritative pronouncements.
Preface	<ul style="list-style-type: none"> —Revised to clarify that the Guide now cites SASs and PCAOB Auditing Standards with AU references. —Revised to alert readers to the issuance of risk assessment standards (SAS No. 104 through SAS No. 111). —Revised to delete last year's discussion of the proposed risk assessment standards as it is no longer relevant. —Revised to indicate that the deferral of the requirement for broker-dealers to be audited by a public accounting firm registered with the PCAOB was extended until January 1, 2007.
Paragraph 1.05	Revised to discuss various kinds of broker-dealers.
Paragraph 1.06	Revised to indicate that many discount broker-dealers have their customers place securities transactions or otherwise manage their brokerage accounts through their Web sites rather than through a registered representative.
Paragraph 1.10	Revised to indicate that in addition to complying with the SEC rules and regulations, government broker-dealers are also subject to certain rules and regulations of the Department of the Treasury.
Paragraph 1.13	Added to define carrying brokers; Subsequent paragraphs renumbered.

<u>Reference</u>	<u>Change</u>
Paragraph 2.95	—Added footnote * to alert readers about the issuance of FASB Statement No. 155, <i>Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140</i> —Deleted definition of derivative and the related footnote as this information already appears in paragraph 7.40 of this Guide.
Paragraph 2.141	Revised to discuss "non-purpose borrows" and added footnote 6 to refer to the related guidance; Subsequent footnotes renumbered.
Paragraph 3.50	Last bullet revised to clarify guidance.
Paragraph 3.64 (footnote †)	Added.
Paragraph 3.70 (footnote ‡)	Added to discuss new portfolio margining rules; Subsequent footnotes redesignated.
Paragraph 3.77	Last bullet revised to clarify requirements for broker-dealers that are also registered as FCMs.
Paragraphs 3.82, 3.83, and 3.84	Added to discuss requirements of recently issued SAS No. 112, <i>Communicating Internal Control Related Matters Identified in an Audit</i> ; Subsequent paragraphs renumbered.
Paragraph 3.90	Added footnote ** to alert readers about two sets of internal control letters contained in appendixes—one in accordance with SAS No. 60 and the other one in accordance with SAS No. 112.
Paragraph 3.93 (footnote ††)	Revised to indicate that the deferral of the requirement for broker-dealers to be audited by a public accounting firm registered with the PCAOB was extended until January 1, 2007.
Paragraph 3.103	—Revised to discuss the impact of AML testing on auditor independence. —Added footnote ††† to alert readers about recent AML regulations.
Paragraph 3.110 (footnote 5)	Deleted information about the impact of SEC rule, <i>Supervised Investment Bank Holding Companies</i> , on Rule 17a-12.
Paragraph 3.114	Revised to clarify SEC rules with respect to reconciliations.
Paragraphs 3.117 and 3.118	—Divided from former paragraph 3.113 to make a distinction between information that needs to be provided by the broker-dealer when filing for an extension and the information that should be included in the accompanying letter from the independent public accountant. —Revised paragraph 3.117 to make the requirements for broker-dealers consistent with NASD Manual.

Reference	Change
Paragraph 3.140 (Heading) (footnote 9)	Deleted.
Paragraph 3.142	Revised to alert readers about NASD and NYSE rules requiring broker-dealers to have CEO certify broker-dealer's compliance with certain rules and regulations.
Paragraph 4.04 (footnote 1)	Deleted; Subsequent footnotes renumbered.
Paragraph 4.11	Revised to discuss the impact of FASB Statement No. 150 on broker-dealers' Statement of Changes in Ownership Equity.
Paragraph 4.13 and heading	—Added footnote † to alert readers about the potential impact of EITF Issue No. 04-5 on broker-dealers. —Revised the list of pronouncements that need to be considered related to consolidations. —Revised footnote ‡ to update the status of FASB project on consolidation policy.
Paragraphs 4.16 and 4.17	Revised (and footnotes 1 and 2 added, respectively) to clarify the reconciliation requirements; Subsequent footnotes further renumbered.
Paragraph 4.62 (footnote)	Revised to alert readers about the issuance of TPAs addressing accounting for leases.
Paragraph 4.64	Revised to discuss the need to consider FASB Statement No. 123(R) if broker-dealer's employees are compensated with equity of the broker-dealer or a related entity.
Paragraph 4.76 (Heading)	Added footnote # to alert readers about the issuance of FASB Statement No. 155, and added footnote ** to alert readers about FASB Derivative Disclosures project.
Paragraph 4.80 (Exhibits 4-1 through 4-9)	Updated dates of sample financial statements, related notes and schedules to reflect 20X6.
Paragraph 4.80 (Exhibit 4-3)	—Revised presentation of the securities and spot commodities owned and the related footnote to be consistent with FASB Statement No. 140. —Revised footnote * and moved it next to applicable line items.
Paragraph 4.80 (Exhibit 4-4)	Revised footnote † to reflect the current status of standard setting developments related to earnings per share.
Paragraph 4.80 (Exhibit 4-6)	Footnotes *, †, and ‡ deleted.
Paragraph 4.80 (Exhibit 4-7) (Heading)	Footnote * deleted; Subsequent footnotes redesignated.

<u>Reference</u>	<u>Change</u>
Paragraph 4.80 (Exhibit 4-8)	<p>—<i>Note 2</i>—deleted footnote *; Subsequent footnotes redesignated.</p> <p>—<i>Note 9</i>—revised to indicate that the carrying amount of subordinated borrowings approximates fair value due to borrowings at market rate base.</p> <p>—<i>Note 11</i>—revised footnote 6 to alert readers about the issuance of FASB Statement No. 158; Deleted former footnote †; Subsequent footnotes further redesignated.</p> <p>—<i>Note 12</i>—former footnote † replaced with footnote †† to alert readers about the issuance of FASB Statement No. 157; Added footnote ††† to alert readers about the issuance of FASB Statement No. 155; Subsequent footnotes further redesignated.</p> <p>—<i>Note 16</i>—added footnote *** about FASB Interpretation No. 48; Deleted former footnote #.</p> <p>—<i>Note 19</i>—revised to make disclosures consistent with the requirements of FASB Statement No. 140.</p>
Chapter 5 (Heading)	Revised footnote * to discuss the issuance of Risk Assessment Standards.
Paragraphs 5.01 and 5.03	Revised to clarify that the report on the broker-dealer's internal control is required by SEC Rule 17a-5(g)(1).
Paragraph 5.12	Added footnote † about the issuance of SAS No. 108.
Paragraph 5.17	Added footnote † about the issuance of SAS No. 107.
Paragraph 5.24	Added footnote # about the issuance of SAS No. 111.
Paragraph 5.27	Added footnote ** about the issuance of SAS No. 106.
Paragraph 5.35 (Subheading)	Added to distinguish guidance based on SAS No. 96 from guidance based on SAS No. 103; Deleted former footnote †; Subsequent footnotes redesignated.
Paragraphs 5.36–5.42	Added guidance about Audit Documentation based on SAS No. 103; Subsequent paragraphs renumbered.
Paragraph 5.53	Added footnote † about the issuance of SAS No. 108.
Paragraph 5.69	Revised footnote 4 to alert readers about the issuance of SAS No. 112.
Paragraph 5.71	Added footnote †† about the issuance of SAS No. 105.
Paragraph 5.72	Added footnote †† about the issuance of SAS No. 109 and 110.
Paragraph 5.76	Revised to be consistent with SAS No. 103.
Paragraphs 5.95 and 5.96	Added to incorporate guidance from Auditing Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist," in AU section 9332 and Auditing Interpretation No. 1, "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value," in AU section 9328; Subsequent paragraphs further renumbered.

<u>Reference</u>	<u>Change</u>
Paragraph 5.100 (Subheading)	Added to distinguish guidance based on SAS No. 60 from guidance based on SAS No. 112.
Paragraphs 5.101, 5.102, and 5.103	Added guidance based on SAS No. 112; Subsequent paragraphs further renumbered.
Paragraph 5.108	—Revised heading to indicate that guidance in this section applies not only to communications with audit committee but also to communications with equivalent bodies. —Added footnote to alert readers about the issuance of an exposure draft of a proposed SAS, <i>The Auditor's Communication With Those Charged With Governance</i> , which will replace SAS No. 61.
Paragraphs 5.114, 5.118, 5.124	Added footnotes †† about the issuance of SAS Nos. 109 and 110.
Paragraph 5.127	Revised to define "service auditors."
Paragraph 5.132	Revised to clarify that the report on the broker-dealer's internal control is required by SEC Rule 17a-5(g)(1).
Paragraph 5.140	Revised to clarify that in addition to auditing procedures discussed in this chapter there are other auditing procedures that need to be performed in the audits of broker-dealers.
Paragraph 5.162	Revised to clarify guidance on third party confirmations based on AU sections 9328 and 9332.
Paragraph 5.170 (former footnote 6)	Deleted; Subsequent footnote renumbered.
Paragraph 5.171	Added to discuss open contractual commitment; Subsequent paragraphs further renumbered.
Paragraph 5.180	—Footnote 6 revised to add guidance on third party confirmations based on AU sections 9328 and 9332. —Table revised the heading of the first column to provide a better description of its contents.
Paragraph 5.181 (Appendix A)	Risk Factors and Auditor Responses, <i>Part 1: Fraudulent Financial Reporting</i> , B.2(c)—replaced terminology to be consistent with SAS No. 112.
Chapter 6	Revised footnote * to discuss the issuance of Risk Assessment Standards.
Paragraph 6.01	Revised to clarify that the report on the broker-dealer's internal control is required by SEC Rule 17a-5(g)(1).
Paragraph 6.03	Added footnote † about the issuance of SAS No. 109 and 110.
Paragraph 6.08	Added footnote ‡ about the issuance of SAS No. 106.

<u>Reference</u>	<u>Change</u>
Paragraph 6.13	Third bullet revised to avoid prescribing specific policies with respect to <i>hiring practices</i> .
Paragraph 6.21	Revised to clarify guidance.
Paragraph 6.24	Revised to elaborate on the potential effect of broker-dealer's noncompliance with applicable rules and regulations.
Paragraph 6.33	Revised to clarify guidance with respect to <i>performance reviews</i> .
Paragraph 6.34	Revised to clarify guidance with respect to <i>valuation (accuracy) and safeguarding of assets</i> .
Paragraphs 6.49 and 6.54	Revised to clarify guidance.
Paragraph 6.57	Added footnote to refer readers to the footnote in chapter 3 discussing new rules on portfolio margining.
Former paragraph 6.63	Deleted; Text from this paragraph as well as former footnote 4 were moved to after the <i>Principal Transactions</i> section; Subsequent paragraphs renumbered.
Paragraph 6.63	Revised to clarify guidance.
Paragraph 6.65 (and heading and footnote 4)	Added to list control procedures reviewing master netting agreements and presentation of netted transactions to ensure that it complies with requirements of FASB Interpretation No. 39, and to clarify guidance related to the valuation of the derivatives portfolio; Subsequent paragraphs further renumbered.
Paragraph 6.67	Former paragraph 6.68 was moved in front of the paragraph discussing <i>Bank Loans</i> to properly reflect relative importance of these activities the operations of a broker-dealer; Subsequent paragraphs further renumbered.
Paragraph 6.69 and heading	—Revised footnote # to reflect the most recent regulatory developments in connection with the SEC requirements for management's report on internal control over financial reporting. —Revised to clarify the applicability of this requirement.
Paragraphs 6.75–6.84	Added section discussing internal risk management control systems of consolidated supervised entities.
Paragraph 7.02 and heading	Revised footnote * to reflect the issuance of FASB Statement No. 157 and to alert readers about the issuance of an Exposure Draft of a Proposed Statement, <i>The Fair Value Option for Financial Assets and Financial Liabilities</i> .
Paragraphs 7.03 and 7.04	Revised to clarify guidance with respect to timing of determining fair value.

<u>Reference</u>	<u>Change</u>
Paragraph 7.14 (footnote 3)	Revised to indicate that the 1993 Group of Thirty Report was updated by the 2003 Report.
Paragraph 7.15	Revised to clarify guidance.
Paragraph 7.18 (and heading)	Revised to indicate that references to principal and proprietary transactions are interchangeable.
Paragraph 7.21	Footnote * added.
Paragraph 7.23	Revised to clarify distinction between broker-dealers acting in a dealer capacity versus broker capacity.
Paragraphs 7.28 and 7.29	Revised to clarify guidance.
Paragraph 7.30	Added footnote † to alert readers about the issuance of FASB Statement No. 156 and a related exposure draft, <i>Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140</i> ; Subsequent footnotes redesignated.
Paragraph 7.30b	Added footnote ‡ to alert readers about the issuance of FASB Statement No. 155; Subsequent footnotes further redesignated.
Paragraph 7.34 (former footnote †)	Deleted; Subsequent footnotes further redesignated.
Paragraph 7.36	Revised to incorporated guidance from former footnote 6 deleted from former paragraph 5.59.
Paragraph 7.37	—Deleted footnote 7; Subsequent footnotes further renumbered. —Revised footnote to update the status of FASB project on consolidation policy.
Paragraph 7.38 (and heading)	—Revised to clarify guidance with respect to evaluation of securitization transactions and to alert readers about the issuance of FSP FAS 140-2, <i>Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140</i> —Added footnote # to alert readers about the issuance of FASB Statement No. 155. —Added footnote † to alert readers about the issuance of FASB Statement No. 156 and a related exposure draft, <i>Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140</i> —Added footnote ** about the effective date of FSP FAS 140-2.
Paragraph 7.39	—Deleted former footnote # about the issuance of FIN 46(R). —Revised footnote †† discussion about FSP FIN 46(R)-5 to discussion about FSP FIN 46(R)-6, <i>Determining the Variability to Be Considered in Applying FASB Interpretation No.46(R)</i> , and the Practice Alert 2005-01, <i>Auditing Procedures With Respect to Variable Interest Entities</i> .

Reference	Change
Paragraph 7.40 (and heading)	—Added footnote †† to alert readers about the issuance of FASB Statement No. 155. —Revised footnote ††† to replace cross-reference to paragraph 2.95 with an expanded discussion of the proposed Practice Aid, <i>Illustrative Disclosure on Derivative Loan Commitments</i> .
Paragraph 7.41	—Revised to clarify guidance and replaced reference to the statement of financial <i>position</i> with the reference to the statement of financial <i>condition</i> to be consistent with other sections of the Guide.
Paragraphs 7.47 and 7.48	Revised to clarify guidance.
Paragraph 7.56 (footnote ††)	Deleted.
Paragraph 7.61	Added to discuss FASB Statement No. 146.
Appendix A	—Updated dates of financial statements and report date. — <i>Footnote 1</i> —revised to update the status of the ASB project to revise AU section 508 and editorial revision. —Added footnote * to alert readers about the issuance of SAS No. 103 and its impact on the dating of the auditor's report.
Appendix B	Updated dates of financial statements and report date.
Appendix C	—Added footnote * to alert readers that this report is based on SAS No. 60. —Updated dates of financial statements and report date in both the report and footnote 1.
Appendix C-1	Added a report that is based on SAS No. 112.
Appendix D	—Added footnote * to alert readers that this report is based on SAS No. 60. —Deleted reference to supplemental schedules in the first paragraph to be consistent with other reports. —Updated dates of financial statements and report date in both the report and footnote 2. —Deleted item 3 from the list of the practices and procedures not reviewed by the auditor in the second paragraph of the report.
Appendix D-1	Added a report that is based on SAS No. 112.
Appendix E	—Updated dates of financial statements and report date. —Revisions to make the terminology used in the report consistent with the current literature.

Reference	Change
Appendix F	<p>—Replaced Appendix F, <i>Report on Internal Control Required by CFTC Regulation 1.16</i>, with appendix for dual registrants entitled <i>Report on Internal Control Required by CFTC Regulation 1.16 and SEC Rule 17a-5(g)(1)</i>.</p> <p>—Added footnote * to indicate that this report is based on SAS No. 60.</p>
Appendix F-1	Added a report that is based on SAS No. 112.
Appendix G	<p>—Updated dates of financial statements and the date through which the representations are given.</p> <p>—<i>Throughout</i>—revised and added numerous representations to address regulatory considerations and to clarify certain items.</p> <p>—<i>First paragraph</i>—replaced reference to the statement of financial <i>position</i> with the reference to the statement of financial <i>condition</i> to be consistent with the preceding reference within this paragraph.</p> <p>—<i>Representation 23</i>—added footnote † to provide readers with representation to be used if SAS No. 112 has been adopted.</p> <p>—<i>Representation 27</i>—deleted as it is redundant with representation 23.</p> <p>—<i>Representation 28</i>—added to address borrowings and financial obligations.</p>
Appendix H	<p>—Miscellaneous changes to make the report consistent with the format being used in practice.</p> <p>—Updated the date of the report.</p>
Appendixes J and K	Updated the dates of the offerings.
Appendixes L and M	Added to provide examples of reporting for consolidated supervised entities; Subsequent appendixes relettered.
Appendix O	Updated contact information.
Glossary	— <i>Fire wall</i> —revised to indicate that this term is interchangeable with the term "systems security."

Glossary

Account executive. See *registered representative*.

Active box. A position on the stock record (street side) indicating securities under the control of the broker-dealer that are normally available for the broker-dealer's general use.

Adequately collateralized. Indebtedness for which the difference between the amount of the indebtedness and the market value of the collateral is sufficient to make the loan acceptable as a fully secured loan to banks that regularly make comparable loans to broker-dealers in the community.

ADR. Abbreviation for American Depository Receipt, a certificate issued by a U.S. bank that serves as evidence of ownership of original foreign shares. These certificates are transferable and can be traded. The original foreign stock certificates are deposited with a foreign branch or foreign correspondent bank of the issuing U.S. bank.

Agency transactions. Transactions in financial instruments that broker-dealers execute on behalf of customers.

Aggregate indebtedness. The total of certain liabilities of a broker-dealer that are set forth in SEC rule 15c3-1. The rule states that a broker-dealer shall not permit its aggregate indebtedness to exceed a specified percentage of its net capital as defined in the rule.

Allied member. Any general partner, qualified voting stockholder, or officer who is deemed to be a control person of a member organization and who is not himself or herself a member of a stock exchange.

AMEX. Popular name for the American Stock Exchange.

Arbitrage. The act of buying a security in one market and simultaneously selling it in another in order to profit from price discrepancies. Also, buying a security subject to exchange, conversion, or reorganization and selling the security or securities to be received upon completion of the exchange, conversion, or reorganization.

Ask. The lowest price a seller is willing to accept for a security at a particular time.

Back office. The operations area of a brokerage office, containing the book-keeping, margin, purchase and sales (P&S), cashier's, and dividend departments.

Bad delivery. A delivery of securities that does not fulfill the requirements for delivery.

Balance order. The net balance instructions, issued by a clearing organization, to receive or deliver securities based on a netting of all trades in a given security settling on the date of netting. The instructions give all the information needed by the member firm to clear its transactions on a given settlement date.

Basis point. A measurement of changes in price or yields for fixed-income securities. One basis point equals .01, or ten cents per \$1,000 per annum.

Best efforts. Refers to an agreement by an underwriter to buy from the issuing corporation only those securities it is able to sell to the public.

Bid. The price a buyer is willing to pay for a security at a particular time.

Big Board. Popular name for the New York Stock Exchange.

Block trading. The acquisition or disposition of large quantities (ten thousand shares or more) or blocks of stock by a broker-dealer in order to facilitate the execution of buy and sell orders of customers, usually institutions. Often, a broker-dealer absorbs a portion of the order for its own account and risk.

Blotter. A record of original entry. A book or individual unit used as a record of original entry to record transactions as they occur. It covers purchases, sales, cash receipts and disbursements, and securities received and delivered.

Blue list. Daily publication, either or both print and electronic, listing primarily municipal bonds offered for sale.

Books closed. The cutoff time that determines the stockholders of record for a prescribed period. Any entries affecting the registration or ownership of securities for dividend disbursements or proxy purposes must be made before this time.

Borrowed. The act of borrowing a security for delivery. The equivalent value in money is usually deposited with the lender.

Box. A term used for a "short" position in the stock record representing securities under the control of or in the possession of the broker-dealer. It indicates a place where securities are kept, such as a vault, file cabinet, and so forth. A box is also identified as a safekeeping box, segregation box, name-of box, active box, and so forth.

Box count. An actual count of securities either in connection with an audit or with periodic checking.

Box spread. A combination of long calls and short puts (identical with respect to the underlying security issue, number of shares, exercise price, and expiration date) coupled with long puts and short calls (identical with respect to the underlying security issue, number of shares, exercise price, and expiration date). In boxing (coupling), the long calls and short puts with the long puts and short calls, the underlying security issue, the number of shares, and the expiration date remain identical. However, the exercise price of each combination is at a different amount.

Break. The term applied to that position in the stock record to designate an out-of-balance position between the stock record long and short positions.

Broker loans. Money borrowed by broker-dealers from banks.

Broker's transfer account. An account kept by the transfer clerk of a broker-dealer giving details of securities transferred for the account of other broker-dealers. The need for the account arises when delivery is made by transfer as directed (TAD) instead of by delivery of the actual certificates.

Bulk segregation. Securities (usually constituting excess collateral in margin accounts) that are filed in alphabetical order in special boxes in the vault but that are not specifically identified by owner. The securities are usually in the name of the broker-dealer, who maintains collateral records that indicate the owners.

Buy in. The procedure followed by a broker-dealer desiring to settle a buy contract that is past due. The broker-dealer may file a notice termed a buy in with a stock exchange or the National Association of Security Dealers, as appropriate. A copy of the notice is also served on the broker-dealer from whom the securities were to be received. If the securities are not delivered, the stock or bond may be bought in for cash for the account of the broker-dealer from whom the securities are to be received. The difference in price between the buy in and the contract price is adjusted by check from one broker-dealer to another.

Buying power. The equity remaining in a margin account after providing for the margining of existing securities in the account in accordance with federal and house margin requirements.

Cage. The term given to the area of the broker's or dealer's office where the cashier, stock clerks, loan clerks, transfer clerks, blotter clerks, and others have, as a part of their duties, responsibility for receiving and delivering securities.

Call (margin). A request, usually in writing, for a margin customer to put up additional collateral (cash or securities).

Call loan. A loan that has no definite maturity or rate of interest. The loan may be either called by the lender or paid off by the borrower at any time.

Call option. A contract that entitles the holder to buy (call), entirely at his or her option, a specified number of underlying units of a particular security at a specified price at any time until the stated expiration date of the contract. (This is an American-style option; a European-style option is exercisable only at a specific date.) Such an option (which is always for a transferable, round-lot amount) is bought with the expectation that the price will rise above the contract price. If the price rises as anticipated, the purchaser will exercise the option; if it does not, he or she will let the option expire and will lose only the cost of the option. There is both a listed and over-the-counter market in options. (During the existence of an OTC option, the exercise price and number of underlying units are adjusted on the expiration date for cash dividends, rights, and stock dividends or splits.)

Carry. The cost of financing (borrowing to buy) a position in financial instruments. Positive carry is a condition that arises if the cost of financing (the short-term rate of interest) is less than the current return of the instrument. Negative carry is a condition that arises if the cost of financing is above the current return of the instrument.

Cash account. The account of a customer of a broker-dealer who purchases and sells securities strictly on a cash basis. No credit margin is allowed.

Cash sale. A sale with the same trade and settlement dates. The selling broker-dealer must be able to make delivery of the security sold on the trade date. The customer who is selling usually receives a discounted price on the sale for this special service.

Cash transaction. A transaction that is expected to clear within the time prescribed by Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System.

- Cashier's department.** A division of the operations department of a broker-dealer that handles the securities and money that are received or delivered by the broker-dealer (see *cube*).
- CBOE.** Abbreviation for Chicago Board Options Exchange, a national securities exchange based in Chicago that provides a continuous market for trading in put and call options. Various other exchanges (such as the American, Pacific, and Philadelphia) also provide such markets.
- CFTC.** Abbreviation for Commodity Futures Trading Commission, an agency established by Congress to regulate U.S. commodity futures markets and futures commission merchants. Among other things, this agency establishes rules governing the minimum financial, reporting, and audit requirements of its members. Its function is similar to that performed by the SEC in regulating broker-dealers in securities and various securities markets.
- Churning.** The process of excessive purchases and sales in customers' accounts for the purpose of generating commissions.
- Cleanup call.** An option held by the servicer or its affiliate, which may be the transferor, to purchase the remaining transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates, or its agents, in a qualifying special-purpose entity (SPE) (or in a series of beneficial interests in transferred assets within a qualifying SPE), if the amount of outstanding assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing.
- Clearance.** The act of clearing securities between buyers and sellers; receipt or delivery of securities against payment.
- Clearing broker.** Usually, a broker-dealer who clears the transaction of another broker-dealer (see *correspondent*).
- Clearinghouse.** The central location for matching commodity transactions of members.
- Clearing member.** A broker-dealer entitled to use the services of the clearing organization.
- Clearing number.** A number assigned to a member by a clearing organization in order to identify that clearing member.
- Clearing organization.** The central location for matching the security transactions of members (see also *clearinghouse*).
- Commodity holdout.** Commodity transactions on the broker's or dealer's records that are not reported on the clearinghouse sheets.
- Commodity spreading.** Implies open purchase (long) and sale (short) contracts in the same commodity or in different commodities.
- Comparison.** A formal notice that details the terms of the contract between broker-dealers that are parties to nonexchange trades. If the details of the trade are correct, the comparison is stamped (acknowledged) and returned; if they are incorrect, the broker-dealer indicates the differences and returns the comparison (see *DK*).
- Compliance department.** The department of a broker-dealer that enforces adherence to policies established by the broker-dealer, plus all rules and regulations promulgated by the various regulatory agencies.

- Confirmation.** A notice that sets forth the terms of a contract between a broker-dealer and its customer for the purchase or sale of securities. Details shown on a confirmation are the trade date, settlement date, number of shares or par value of bonds, security description, contract price, commission, account number and type of account, and customer's name and address, as well as any other information required.
- Contract difference.** The difference between the contract and the market values of commodities.
- Contract sheet.** A listing of compared and un-compared transactions sent to each member firm by a stock-clearing corporation.
- Control stock.** Securities of an issuer that are owned by an affiliate of that issuer. An affiliate of that issuer is a person who, directly or indirectly through one or more intermediaries, controls or is controlled by or is under common control with the issuer. Control is likely to be found if the person is a director, officer, or owner of a relatively large number of the issuing company's voting securities. However, the notion of control is a factual matter that is determined on a case-by-case basis.
- Correspondent.** One of the parties to an agreement between two broker-dealers who perform services for each other, such as the execution and the clearance of trades or the maintenance of customer accounts.
- Cover value.** The amount necessary to buy-in a short security position at the current market value.
- CRD.** (Abbreviation for Centralized Registration Depository, a computerized filing and data processing system, operated by the National Association of Securities Dealers, that maintains registration information regarding broker-dealers and their registered personnel.
- Credit department.** See *margin department*.
- Current market value.** As used in connection with margin trading, generally the closing price of a security as of the preceding business day.
- CUSIP number.** A means of uniformly describing and identifying all stocks and registered bonds in numeric form developed by the Committee on Uniform Security Identification Procedure.
- DAP.** Abbreviation for delivery against payment. Also referred to as COD (cash on delivery), POD (payment on delivery), and DVP (delivery versus payment).
- Day loan.** A loan made for only one day, generally on an unsecured basis, for the convenience of the broker-dealer.
- Definitive certificates.** Actual and permanent certificates of bonds or stock given in exchange for temporary receipts. These temporary receipts are usually issued at the time of a new offering, before the engraved certificates are available.
- Delayed delivery.** A transaction involving deferral of the settlement date (which is normally three business days for securities and one business day for options) to some point further in the future as agreed on by both buyer and seller (see *seller's option*).
- Directed sale.** Sale by the manager of a syndicate to a customer, usually an institution, of a syndicate member.

Discretionary account. An account over which a broker-dealer or some other person has been given authority by the customer to make decisions (including the kind of securities to buy or sell, as well as the date and prices to be paid or received) concerning purchases and sales of securities. The discretion may be complete or limited.

Distribution. The sale of a large block of securities to the investing public.

Divided liability. Liability in a syndicate or underwriting that is fixed or definite in the amount of shares or principal value for each participant (see *undivided liability*).

Dividend department. A division of the operations department that is charged with the collection of dividends and the crediting of these dividends to the accounts of customers.

DK. Abbreviation for don't know, an expression used by a broker-dealer to indicate that a transaction another broker-dealer is attempting to confirm or compare is unknown or is questioned (meaning that it is a questioned trade or a QT). When mutual understanding is reached, the transaction is properly compared or canceled.

DTC. Abbreviation for Depository Trust Company, a depository for eligible securities that facilitates clearance between member organizations and banks without the necessity of receiving or delivering actual certificates.

Due bill. A document, used to adjust security transactions, passed between broker-dealers stating that dividends, rights to subscribe, stock dividends, and so forth, are the property of the holder of the due bill.

DVP. Abbreviation for delivery versus payment.

Equity. The net worth in an account carried by a broker-dealer, computed by subtracting the total of the short security values and the debit balance from the total of the long security values and the credit balance. If the result is a net credit, the account is said to liquidate to an equity.

Equity securities. Term applied to common and preferred stocks.

Equity statements (runs). Statements showing details of an account with security valuations.

Exchange tickets. The tickets in a clearing corporation format, prepared by a broker-dealer for each transaction made on an exchange. These tickets list all pertinent details of the trade and are sent, along with a daily summary listing, to the clearing corporation for comparison and confirmation.

Ex-clearinghouse. Transactions that are not settled through the clearinghouse.

Ex-dividend. Synonym for without dividend. The buyer of a stock selling ex-dividend does not receive the recently declared dividend. Open buy and sell stop orders and sell stop limit orders in a stock on the ex-dividend date are ordinarily reduced by the value of the particular dividend. In the case of open stop limit orders to sell, both the stop price and the limit price are reduced. Every dividend is payable on a fixed date to all shareholders recorded on the books of the disbursing company as of a previous date of record. For example, a dividend may be declared as payable to holders of record on the books of the disbursing company on a given Friday. Since

three business days are allowed for delivering the security via regular-way delivery in transactions on a stock exchange, the exchange would declare the stock ex-dividend as of the opening of the market on the preceding Wednesday. This means that anyone buying the stock on and after Wednesday would not be entitled to the dividend.

Execution report. A confirmation notice of the completion of a trade that is sent from the floor of an exchange (for listed securities) or trading desk (for over-the-counter securities) back to the point of origin of the order.

Exempt securities. Securities exempted from registration under the Securities Exchange Act of 1934, rather than by action of the Securities and Exchange Commission. Such securities include U.S. government and agency securities, and municipal bonds.

Ex-rights. Same principle as ex-dividend. The buyer of stock selling ex-rights is not entitled to the rights distribution.

Extension. Permission to extend credit beyond the time prescribed by Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System.

Ex-warrants. On occasion, stocks or bonds have warrants attached entitling the holder to subscribe to additional shares within specified periods of time and at specified prices. If these warrants are detached, the security is traded ex-warrants.

Fail-to-deliver. Securities that the selling broker-dealer has not delivered to the purchasing broker-dealer at the settlement date.

Fail-to-receive. Securities that the purchasing broker-dealer has not received from the selling broker-dealer at the settlement date.

Fails. Uncompleted security transactions between two broker-dealers (see *fail-to-deliver*; *fail-to-receive*).

Financial consultant. See *registered representative*.

Fire wall. (Also referred to as "systems security.") An intangible barrier between the trading side of a broker-dealer and the corporate finance and research side that prevents broker-dealers from taking advantage of the corporate finance department's inside information.

Firm account. An account consisting of securities in which the broker-dealer has taken a position for investment purposes, is making a market (principal wholesaler), or has an interest with another party (joint account).

Firm commitment. The agreement of an underwriter to buy the entire issue of a security from the issuing corporation at a specified price.

Firm price. The price at which a security can be bought or sold in the over-the-counter market for such period of time as the seller may specify.

Flat. A method of trading in certain kinds of bonds. Usually used in trading income bonds that do not pay interest unless it has been earned and declared payable, or in bonds on which the issuer has defaulted in the payment of interest. When bonds are traded "flat," the seller is not entitled to the interest that has accumulated since the date of the last interest payment. The seller of a bond that is traded flat must deliver the bond with all unpaid coupons attached or a due bill authorizing the buyer to collect any payments of interest that may be made by the issuer in the future.

Flat statement. A statement with no money or security balance.

Floor. Popular name for the area where securities are bought or sold at an exchange.

Floor broker. Member of exchange who executes transactions on the floor of an exchange for the account of his or her own organization or for the account of other member organizations.

Floor brokerage. The commission charged by one broker-dealer to another for executions of transactions at exchanges.

Floor clerk. An employee of a broker-dealer who maintains a liaison between the order room and the floor broker.

Floor report. A report of an executed trade given to the floor clerk by the floor broker and containing the number of shares, the price, and the identity of the other broker on the trade.

FOCUS report. Acronym for Financial and Operational Combined Uniform Single report. The uniform regulatory report (Form X-17A-5) filed periodically by all broker-dealers pursuant to rule 17a-5 of the Securities and Exchange Commission.

Forward market. Reference made to nonexchange trading of commodities and securities for settlement at a future date. Contracts of this nature are designed by both the buyer and seller as to the delivery time, the amount, and so on.

Free securities. Securities that are fully paid for.

Free shipment. Shipments of securities, usually to out-of-town broker-dealers, without a draft attached, in order to avoid payment of collection charges.

Fully disclosed basis. Situation in which a nonclearing broker introduces a customer to a clearing broker and the customer's name and statement are carried by, and disclosed to, that clearing broker.

Fully paid accounts. Customer accounts in which the contract price to purchase securities has been paid. These securities should be locked up in the segregation or safekeeping box.

Fungibility. Similar securities that are interchangeable, such as Government National Mortgage Association securities transactions that are interchangeable as to interest rate and pool and are traded and settled at an equivalent yield basis.

Futures contract. An exchange-traded contract for the purchase or sale of commodities at some time in the future.

Give-up. Type of order that is given by a customer to a member firm on whose books the customer does not have an account.

GNMA. Abbreviation for Government National Mortgage Association. GNMA modified pass-through certificates are bought and sold on a current or delayed settlement-date basis.

Good delivery. Certain basic qualifications that must be met before a security sold may be delivered. The security must be in proper form to comply with the contract of sale and to transfer title by delivery to the purchaser.

Good-faith deposit. Deposit to guarantee performance, usually with respect to new issues of securities.

Group account. A syndicate or joint account.

GTC. Abbreviation for good till canceled. Also called an open order. If this term appears on an order to buy or sell a security, it means that the order is to remain in effect until it is either executed or canceled.

Haircut. Deductions from the net capital of certain specified percentages of the market value of securities and commodity futures contracts that are long and short in the capital and proprietary accounts of a broker-dealer and in the accounts of partners. These deductions are solely for the purpose of computing net capital and are not entered on the books.

Half turn. A transaction involving the purchase or sale as either an opening or closing transaction of a commodity futures contract (see *round turn*).

Holder of record. The party listed as the owner on the transfer records of a corporation.

Holder's file. A subsidiary file (punched cards, discs, or tapes) in account sequence showing securities owned or carried in such accounts.

House account. An account used by a broker-dealer to maintain a trading or investment position in a security for itself or its officers or partners. Also, a name given to a customer's account to which no registered representative has been assigned.

House rules. Rules promulgated by the broker-dealer. Usually refers to the maintenance margin required by the broker-dealer over and above the requirements of regulatory bodies.

Hypothecation agreement. An agreement signed by a customer that permits his or her broker to use securities in the customer's margin account as collateral for loans made to the broker.

In-box sheet. A sheet that includes a list of items going into the box.

In-house. Within the broker's or dealer's firm.

Initial margin. The amount of money or its equivalent, specified by the Board of Governors of the Federal Reserve System, that a customer must deposit with his or her broker when the customer buys a security on margin.

Interest trades. These transactions, as defined, involve (1) a purchase of Government National Mortgage Association (GNMA) securities for current settlement; (2) a delayed settlement sale of these securities or the possession of a long standby; and (3) a financing of the long GNMA position by a sale under an agreement to repurchase on or before the future delivery date.

International arbitrage. Same as arbitrage, except the markets are in different countries.

Investment banker. One who underwrites securities on an initial or secondary basis. This type of underwriting often involves private placements for which the investment banker may act as both a broker and a dealer.

Joint account. An account in which two or more persons have an interest.

Legal list. A list of securities in which insurance companies, banks, and fiduciaries are permitted by law to invest.

Legal transfer. A stock certificate having an assignment executed by an executor, administrator, trustee, guardian, and so forth, and requiring certain legal documents indicating the authority of the party signing the securities.

Letter of credit. An unqualified commitment issued by banks or trust companies to pay a specified sum of money immediately upon demand at any time prior to the expiration of the letter of credit. Most commonly used by broker-dealers to satisfy margin requirements at the Options Clearing Corporation or commodity-clearing organizations or in stock-borrowed transactions.

Limit order. Also called a limited order or limited price order, an order to buy or sell a security at a price specified by the customer or at a better price, if such a price can be obtained.

Listed security. A security that is traded on an exchange.

Loan consent. An agreement signed by a customer that permits the broker-dealer to lend securities owned by the customer to other broker-dealers.

Loaned. The act of lending a security, usually for delivery against a short sale. The equivalent value in money is usually deposited by the borrower. This term is the opposite of *borrowed*.

Loanet. An independently owned and operated on-line real-time accounting service used by brokers and institutions in support of their domestic and international securities borrowing and lending activities. The system provides interfaces to the Depository Trust Company for both receipt and delivery of securities, including market values of the securities, and to clients' internal recordkeeping systems or outside accounting services. In addition, Loanet also provides daily contract comparison for all subscribers engaged in the borrowing and lending of securities and portfolio availability of most major lending institutions.

Loan value. The value at which a security is accepted for margin. This value is usually less than, or at a discount from, the current market value.

Lock-up. The act of placing securities in safekeeping or segregation.

Long. Denotes ownership, or the right to possession, of securities.

Long and short record. See *stock record*.

Long securities differences. The excess of securities positions accounted for over the broker-dealer's long positions on the stock record. When recorded in a difference account, the excess would be recorded long on the stock record (see *short securities differences*).

Maintenance margin. The amount of equity required to be maintained in a margin account in accordance with exchange regulations or house rules.

Margin. The equity in an account. The requirements for the amount of margin vary between initial margin and maintenance margin and also according to the type of collateral used in computing the equity.

Margin call. A request for additional margin.

Margin department. A division of the operations department. Its functions include keeping an up-to-date record of each customer's purchases and sales of securities, carefully monitoring extensions of credit to customers, and the segregation of fully paid for or excess-margin securities.

Margin transaction. A transaction in which the broker-dealer advances credit to the customer for a portion of the purchase price.

Market maker. A broker-dealer that stands ready to buy or sell a particular security in the over-the-counter market at prices the broker-dealer has quoted. Also, an options trader on the floor of a registered exchange who stands ready to buy or sell a particular option.

Market price. Usually means the last reported price at which a security has been sold.

Mark to market. Term used to describe the process of valuing (market value or fair value) security positions, which is recognized as the generally accepted accounting principle for purposes of determining profit or loss on security positions in proprietary trading and investment accounts. The term also is applied to open contracts between broker-dealers and clearing corporations for determining the adjustments to be made for funds owed or receivable as a result of adjusting those contracts to current values.

Mark up. The difference between what a broker-dealer has paid for a security and the price at which it offers the security to another person.

Master file. A file that contains the official account numbers and descriptions of securities and customers' names and addresses.

Matrix pricing. A mathematical technique used to value normal institutional-size trading units of debt securities without relying exclusively on quoted prices of the specific security. Factors such as the issue's coupon or stated interest rate, maturity, and rating and quoted prices of similar issues are considered in developing the issue's current market yield.

Maximum loan value. The percentage of the purchase price of a security that a broker-dealer may lend to a customer who is buying a security on margin.

Member corporation. A broker-dealer that is organized as a corporation and that has at least one director-holder of voting stock who is a member of an organized stock exchange.

Member firm. A broker-dealer that is organized as a partnership and that has at least one general partner who is a member of an organized stock exchange.

Mixed account. An account containing both long and short securities.

Municipal Securities Rulemaking Board (MSRB). Agency established by Congress to establish rules for broker-dealers effecting transactions in obligations of, or guaranteed by, state or local governments or any agency or instrumentality thereof.

Name-of securities. Securities registered in the name of customers of the broker-dealer (see *safekeeping*).

NASD. Abbreviation for National Association of Securities Dealers, Inc. An association of broker-dealers who do business in the over-the-counter market.

The association supervises and regulates the trading conduct and sales practices of its members.

NASDAQ. Abbreviation for National Association of Securities Dealers Automated Quotation System. An electronic quotation system for the over-the-counter market.

Net capital. Net worth of a broker-dealer, less certain items such as exchange memberships, the carrying value of securities that are not readily marketable, haircuts on marketable securities in proprietary accounts, furniture and equipment, and other illiquid assets, as defined in the net capital rules.

New issue. A security that is sold by an issuing corporation for the first time. It may be referred to as an initial public offering.

No-action letter. A letter issued to a broker-dealer by the staff of the Securities and Exchange Commission (SEC) in response to a request filed by the broker-dealer describing a proposed business activity that may or may not conform to SEC rules and regulations. In a no-action letter, the SEC staff indicates that, based on the facts presented by the broker-dealer, the SEC staff will recommend no action be taken against the broker-dealer for engaging in the proposed activity. A no-action letter does not have the force of law; however, it represents an interpretation of the SEC staff that may be applied in a situation where the broker-dealer is engaging in an activity not addressed by existing SEC rules and regulations.

NSCC. Abbreviation for National Securities Clearing Corporation, an independent organization established by the New York and American Stock Exchanges and the National Association of Securities Dealers as an equally owned subsidiary to provide trade processing, clearance, delivery, and settlement services to its members. It deals with brokers, dealers, and banks in the United States and Canada.

NYSE. Abbreviation for New York Stock Exchange, a not-for-profit corporation that is the largest securities exchange in the United States. This self-regulatory organization also furnishes facilities for its members, allied members, member firms, and member corporations to aid them in conducting securities business.

Odd lot. A quantity of securities that is less than the trading unit or round lot, usually a quantity less than an even one hundred shares.

Off-board. Used to describe transactions in listed securities that are not executed on a stock exchange.

Offer. The lowest price at which a seller is willing to sell a security.

Omnibus account. An open account carried and cleared by another broker-dealer and containing accounts of undisclosed customers on a commingled basis that are carried individually on the books of the broker-dealer introducing the trade.

Operations department. The name associated with the overall clerical functions of a broker-dealer. Sometimes referred to as the back office.

Option conversion accounts. Accounts consisting of long options and short options positions and a related underlying securities position (see *conversion*; *reversal conversion*).

- Optional commitment.** A call exercisable at a future date. A long optional commitment is an option to purchase Government National Mortgage Association securities; a short optional commitment is an option to sell.
- Optional commitment fee.** The amount received or paid for the sale or purchase of an optional commitment.
- Optional dividend.** A dividend that is payable in either stock or cash at the option of the holder of record.
- Order department.** A division of the operations department that receives customers' orders and transmits them either to the floor of a stock exchange or to the trading department for execution. The order department also receives notices of executed trades and transmits such notices to the purchases and sales department and to the registered representatives.
- Order room.** Another name for the order department.
- OTC.** Abbreviation for over the counter. A market for securities made up of broker-dealers that may or may not be members of a securities exchange. Thousands of companies have insufficient shares outstanding, stockholders, or earnings to warrant application for listing on a stock exchange. Securities of these and other companies are traded in the OTC market between broker-dealers that act as either principals or brokers for customers. The OTC market is the principal market for U.S.-government and corporate bonds and municipal securities.
- Out-of-box sheet.** A sheet listing securities removed from the box.
- Overdelivery.** Delivering a greater amount of securities than called for, the surplus amount being returned by transferring it to the name of the delivering broker-dealer. An overdelivery can also occur if excess securities are delivered in error.
- Over the window.** The direct delivery of securities between two brokerage concerns, rather than by use of the clearinghouse facilities. Delivery is made by hand to the receive window of the broker and is said to be "over the window."
- Pair off.** This can occur if two broker-dealers owe each other the same number of shares of the same security. Instead of actually receiving the security and delivering it back again, they will "pair off" the transaction by giving or receiving a check for the difference in price or exchanging checks for the full amount of each side of the transaction.
- Papers.** A term sometimes given to put and call options.
- Payable date.** The date on which a dividend is payable to holders of record as of some previous date.
- Pink sheets.** A listing of over-the-counter securities published on pink paper by the National Quotation Bureau. It shows the broker-dealers making a market in the securities shown and sometimes reflects the most recent bid and ask prices for the securities listed. Although pink paper is used for stock quotations, the definition also applies to the listings of bond quotations and so forth, which are printed on papers of a different color.
- Point.** If used in connection with the purchase or sale of stocks, point means a rise or decline of \$1 per share. If used in connection with the purchase or sale of bonds, it means a rise or decline of \$10 per \$1,000 principal amount.

Point balance run. A listing of each commodities futures contract by month of contract on which the extended contract value and market value are indicated together with the resulting gain or loss.

Position. This term is used in referring to the securities "long" or "short" in an account or in the stock record.

Post. A designated place on an exchange floor where specific securities must be traded.

Private placement. The direct sale of a block of securities, either a new issue or a secondary issue, to a single investor or a group of investors. This is usually accomplished through an investment banker.

Proprietary transactions. Transactions in financial instruments that broker-dealers execute for their own account.

Proxy department. A division of the operations department that helps corporations communicate with their stockholders in cases in which stock certificates are in street name.

Purchase and sales department. A division of the operations department that is concerned with the preparation of customers' confirmations of security transactions and the comparison of such transactions with other brokerage concerns.

Put option. A contract that entitles the holder to sell (put), entirely at his or her option, a specified number of underlying units of a particular security at a specified price anytime until the stated expiration date of the contract. (This is an American-style option; a European-style option is exercisable only at a specific date.) Such an option, which is always for a round-lot amount and which is transferable, is bought with the expectation of a price decline below the contract price. If the price decline occurs, the purchaser will exercise or sell the option. If the decline does not occur, he or she will let the option expire and will lose only the cost of the option. There are both listed and over-the-counter (OTC) markets in options. During the existence of an OTC option, the exercise price and number of underlying units are adjusted on the ex-date for cash dividends, rights, and stock dividends or splits.

Puts and calls. Options to sell (put) or buy (call) securities within a specified period of time at specified prices (see *put option*; *call option*; *straddle*).

Quote. The price of a security. It may be the price of the last sale made on an exchange or the current bid and ask price.

Receive-and-deliver department. A division of the operations department responsible for the physical receipts and delivery of incoming and outgoing securities. Often, it is also responsible for the daily balancing of cash entries made by the various operations departments.

Record date. The date on which the stockholder's name must be registered on the books of a company in order to receive a declared dividend or among other things to vote on company affairs.

Registered owner. The owner of a security, whose name is recorded on the face of the certificate and on the books of the issuing corporation or its agent.

- Registered representative.** Salesperson (often referred to as an account executive) of the broker-dealer. Salespeople are registered with the CRD (see *CRD*).
- Registered trader.** Individuals or entities who have obtained approval to trade for their own account on the floor of a national securities exchange. Such individuals or entities have certain obligations with regard to the stabilization of the market in securities for which they are registered. They also have less stringent financial responsibilities and reporting requirements than do full-service broker-dealers.
- Registrar.** Usually a trust company or bank charged with the responsibility of preventing the issuance of more stock than that authorized by the issuing company.
- Regular way delivery.** Unless otherwise specified, the delivery of securities (other than those of the U.S. government) to the buying broker-dealer by the selling broker-dealer, with payments received on the third business day after the transaction. The regular-way delivery day for government bonds is the business day following the transaction.
- Regulation G.** The Federal Reserve Board regulation governing the amount of credit that persons other than banks or broker-dealers may extend to investors who borrow money to buy securities on margin.
- Regulation T.** The Federal Reserve Board regulation governing the amount of credit that broker-dealers may extend to customers who buy securities.
- Regulation U.** The Federal Reserve Board regulation governing the amount of credit that banks may extend to customers, including broker-dealers, who borrow money to buy securities on margin.
- Regulation X.** The Federal Reserve Board regulation specifying conditions with which a borrower must comply when obtaining credit for the purpose of purchasing or carrying securities.
- Reorganization department.** A division of the operations department that processes securities involving corporate reorganizations, mergers, consolidations, subscriptions, and the exchange of convertible securities into common stocks.
- Repurchase agreement (repo agreement).** The sale of a security, usually a U.S. government obligation or corporate debt instrument, at a specified price with a simultaneous agreement to repurchase the security, usually at a fixed or determinable price on a specified future date. An agreed-upon interest rate is accrued by the seller-repurchaser over the life of the contract. For financial reporting purposes, the security is treated as part of the broker-dealer's trading and investment inventory, with the amount of the repurchase agreement reflected as a liability.
- Restricted account.** This means that a broker may not buy securities for a particular customer for a specified period of time unless the customer has deposited enough money in his or her account to pay for the securities before the customer's orders are executed.
- Reverse repurchase agreement (reverse repo or resale agreement).** An agreement whereby the purchaser of securities agrees to resell the

securities within a specified time at a fixed or determinable price (see *repurchase agreement*).

Reverse split. Opposite of stock split.

Rights. The privilege offered by a corporation to its stockholders to subscribe to certain securities, usually at a advantageous price.

Round lot. A unit of trading or a multiple thereof. On the New York Stock Exchange, the unit of trading is generally one hundred shares in stocks and \$1,000 par value in bonds.

Round turn. A purchase and a subsequent sale, or a sale and a subsequent purchase, of a commodity futures contract. Commissions are usually charged to the customers' accounts on a round-turn basis.

RVP. Abbreviation for receive versus payment.

Safekeeping. A position on the stock record (street side) indicating securities that have been fully paid for by customers and that are being held by the broker-dealer under custody arrangements. These securities are generally registered in the name of the customer.

Safekeeping box. Location in which customers' fully paid-for securities are kept.

SCA. Abbreviation for subsequent coupons attached.

Scrip. A certificate issued to stockholders of a corporation that may be exchanged for fractional shares of stock or the equivalent in cash by a fixed date. Scrip is usually issued in connection with a stock dividend or a stock split.

Seat. Popular name for a membership on a stock exchange.

SEC. Abbreviation for Securities and Exchange Commission. An agency established by the U.S. Congress to administer federal securities laws.

Secondary distribution. The sale of a large block of listed securities (other than an initial issue of a corporation) outside of the exchange on which they are listed. It is usually the holdings of a large individual stockholder or an estate that are being liquidated.

Securities borrowed. See *borrowed*.

Securities loaned. See *loaned*.

Securities not readily marketable. This term refers to (1) securities, except exempted securities, for which there is no market on a securities exchange or no independent publicly quoted market; (2) securities that cannot be publicly offered or sold unless registration has been effected under the Securities Act of 1933 (or the conditions of an exemption, such as Regulation A under section 3(b) of this act, have been complied with); or (3) securities that cannot be offered or sold because of other arrangements, restrictions, or conditions applicable to the securities or the broker-dealer.

Segregation. A position on the stock record (street side) indicating customers' fully paid-for or excess-margin securities that are subject to the customers' instructions and that have been set aside. These securities are generally in the name of the broker-dealer (see *bulk segregation*).

- Segregation box.** Location in which segregated securities are kept.
- Sell out.** Action taken by a broker-dealer to liquidate an account or transaction for failure to maintain proper margin or make timely payment.
- Seller's option.** Transaction that, by agreement, is to be settled at a date later than the usual regular-way transaction.
- Selling against the box.** This is similar to a short sale except that the seller already owns the stock being sold but keeps possession of it and so has to borrow the equivalent stock with which to make delivery to the purchaser.
- Selling concession.** A discount in the public offering price offered by the issuer to members of its underwriting group.
- Selling group.** A group of broker-dealers that has formed a joint account for the sale of securities, usually in connection with an underwriting.
- Service bureau.** A data processing center that processes the transactions of broker-dealers. These centers are located away from the broker-dealer's office.
- Settlement date.** The date on which a security transaction is to be settled by the delivery or receipt of securities and the receipt or payment of cash.
- Settlement price.** The price at which a security or commodity is to be settled. Used primarily in connection with clearing organization operations.
- Short.** A stock record position (street side) that represents location (such as box, transfer, and so forth) or due from (such as failed to receive or owed to the brokerage concern by a customer.)
- Short against the box.** See *selling against the box*.
- Short covering.** The purchase of securities so that stock previously borrowed to make delivery on a short sale may be returned.
- Short sale.** A sale of securities that requires borrowing equivalent securities to make delivery to the purchaser.
- Short securities differences.** The excess of securities positions for which the broker-dealer is accountable on its stock record (longs) over those whose locations have been accounted for (shorts) after a securities verification. When recorded in a difference account, the excess would be recorded short on the stock record. See *long securities differences*.
- SIAC.** Abbreviation for Securities Industry Automation Corporation. An independent organization established by the New York and American Stock Exchanges as a jointly owned subsidiary to provide automation, data processing, and clearing and communication services to the securities industry, including the National Securities Clearing Corporation.
- Signature guarantee.** In order that a registered security may be a good delivery on the exchange or a good transfer, the signature of the registered owner must be properly guaranteed. The guarantee of a stock exchange member or a bank is usually considered sufficient guarantee.
- SIPC.** Abbreviation for Securities Investor Protection Corporation, a corporation established for the purpose of protecting customers of broker-dealers in financial difficulty.

- Specialist.** A broker who is a member of an exchange and who operates on the floor of the exchange to execute transactions and to maintain an orderly market in certain specified securities.
- Special offering.** The sale of a large block of securities on the floor of a stock exchange. The sale is made in accordance with special procedures worked out by officials of the exchange.
- Split.** The action of increasing the number of outstanding shares of stock of a company in order to decrease the market price and afford a greater distribution of the shares. For example, two shares for each share held will have the effect of reducing the price of the shares by approximately one-half.
- Spot.** (1) The actual commodity as distinguished from a futures contract. (2) An outgrowth of the phrase "on the spot," it usually refers to a cash market price for stocks of the physical commodity that are available for immediate delivery. (3) This term is also used when referring to the futures contract of the current month, in which case trading is still "futures" trading but delivery is possible at any time.
- Spread.** A combination of a put and call option at different prices—one below and the other above the current market price. Also refers to the difference between the bid and asked prices of a security.
- SRO.** Abbreviation for self-regulatory organization. An SRO, of which a broker-dealer is a member, assumes responsibility for monitoring the broker-dealer's compliance with minimum financial and related reporting requirements.
- Standby.** A put exercisable at a future date. A long standby is an option to sell Government National Mortgage Association securities; a short standby is a commitment to buy.
- Standby fee.** A negotiated amount received or paid for the sale or purchase of a standby.
- Stock dividend.** A dividend payable in the stock of the issuing corporation.
- Stock power.** A legal document used in lieu of the assignment section of a stock certificate.
- Stock record.** The record of individual securities on which both the long and short positions are shown. For each security, the total of the long positions and the total of the short positions should be in balance.
- Stock record department.** A division of the operations department that keeps up-to-date records of all securities positions, and is usually responsible for reconciling out-of-balance conditions.
- Stock split.** See *split*.
- Stockholder of record.** A stockholder whose name is registered on the books of the issuing corporation.
- Stop order.** Also called a stop loss order, this is an order used by a customer to protect a paper profit in a security or to keep down a possible loss in a security. The stop order becomes a market order if the price of the security reaches or sells through the price specified by the customer.
- Straddle.** A combination of one put and one call, identical with respect to the security issue, number of shares, exercise price, and expiration date.

- Street.** A shortened term for Wall Street that refers to brokers, dealers, and other financial business concerns.
- Street item.** A transaction or account between broker-dealers (for example, fail-to-receive, fail-to-deliver, stock loaned, and stock borrowed).
- Street name.** Securities held in the name of a broker-dealer instead of in customers' names are said to be carried in street name.
- Striking price.** The price at which Government National Mortgage Association securities can be purchased or sold upon the exercise of a standby or optional commitment. The price at which an option (put or call) can be exercised (sometimes called the exercise price).
- Subscription.** The offer to purchase a certain offering, such as a certain number of shares of the stipulated stock or principal amount of bonds, for a stipulated amount of money. The offer is not binding unless accepted by the proper authorized representatives of the issuing corporation.
- Substitution.** The act of withdrawing securities from a bank loan and substituting other securities of approximately equal value.
- Suspense account.** An account used to record securities or monies that cannot be immediately identified and cleared (for example, reclamations, DK items, and bad deliveries).
- Syndicate.** A group of broker-dealers that underwrites and distributes new issues of securities or large blocks of an outstanding issue.
- TAD.** An acronym for transfer as directed.
- Takeoff.** Sometimes referred to as a daily activity list, this is a daily record showing the net changes in each security. A separate record is prepared for each security, and the information is used to post (update) the stock record. Also, a record of the long and short positions in a security on the record date, used by the dividend department to make the appropriate dividend entries.
- Tax stamp.** A rubber-stamp facsimile (in some instances, a documentary stamp) affixed to a certificate to indicate that all applicable transfer taxes for the item have been paid.
- TBA.** Abbreviation for to be announced future government sponsored enterprises' pools that are bought and sold for future settlement. TBA refers to the announcement of the specific pools to be delivered or received.
- Ticker.** An instrument that prints the price at which a security has been traded on an exchange after the trade has been executed.
- Time loan.** A loan having a definite date of maturity and a specified rate of interest for the entire period.
- Trade.** A term that indicates the consummation of a security transaction, either a purchase or a sale.
- Trade date.** The date on which a security transaction is actually executed.
- Trader.** An employee of a broker-dealer who executes orders in the over-the-counter market for customers. Also, a person who buys or sells securities for his or her own or his or her company's account for short-term profit.

Trading post. Another name for post.

Trading unit. The unit by which the security is traded on an exchange, usually one hundred shares of stock or \$1,000 principal amount of bonds (see *round lot*).

Transfer. Usually refers to the act of changing the ownership of registered securities on the books of the issuing corporation.

Transfer agent. A transfer agent keeps a record of the name and address of each registered shareholder and the number of shares each owns. The agent sees that certificates presented to his or her office for transfer are properly canceled and that new certificates are issued in the name of the transferee.

Transfer department. A division of the operations department that matches, processes, and controls securities being transferred.

Two-dollar broker. A name given to a member of an exchange who executes orders for other brokers on that exchange.

Underwriting. The act of distributing a new issue of securities or a large block of issued securities, that is, a secondary offering.

Undivided liability. An arrangement whereby each member of an underwriting syndicate is liable for his or her proportionate share of unsold securities in the underwriting account regardless of the number of securities the member has previously sold.

Undue concentration. The additional haircut from net capital (see SEC rule 15c3-1) on the market value of certain proprietary security positions of a single class or series of the same issuer that exceeds ten percent of a broker's or dealer's net capital before haircuts.

Unlisted security. A security that is not listed on an exchange.

Up-front fee. The amount of cash paid to a delayed-settlement to-be-announced securities or Government National Mortgage Association purchaser that is offset by an increase in the sales price.

Value date. Same as *settlement date*.

Valued stock record. The stock record at the examination date, with each security position other than those in segregation and safekeeping assigned a price. Remaining quantities within the position are valued at the assigned price.

Variation margin. A term, used in commodity operations, that refers to the last-day point fluctuation (the difference between the prior day's settling price and the last day's settling price) on net positions long and short.

Warrants. Rights to purchase additional securities. Usually affixed to the certificate at the time securities are originally issued. Also, a document evidencing rights, for instance, a warrant for one hundred twenty-five rights.

When-distributed. Refers to the distribution of new securities. Transactions are sometimes entered into on a when-distributed basis before the distribution takes place.

When-issued. A short form of *when, as, and if issued*. The term indicates a conditional transaction in a security authorized for issuance but not yet

actually issued. All when-issued transactions are on an "if" basis, to be settled if and when the actual security is issued.

Window. A term applied to a place in the office of a broker-dealer where securities are actually received or delivered.

Window ticket. A term applied to a document given to the broker-dealer by a transfer agent as a receipt. Also applies to a transfer document originating with the brokerage concern (broker-originated window ticket).

Wire house. A brokerage concern that has a network of communications (telephone or teletype) that links the main office to branch offices and to offices of correspondent brokerage concerns.

Wire room. See *order department*; *order room*.

Yield. The return on investment that an investor will receive from dividends or interest. The return is expressed as a percentage of the current market price of the security or, if the investor already owns the security, of the price he or she paid. The return on stocks is computed by dividing the total dividends paid in the past calendar year by the price of the stock. The return on bonds is computed by dividing the interest by the price of the bid and is computed as yield to maturity or as yield to earliest call.

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