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Securities industry developments - 2005/06; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Securities Industry Developments — 2005/06

Strengthening Audit Integrity
Safeguarding Financial Reporting

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Notice to Readers

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

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

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

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Securities Industry Developments—2005/06

How This Alert Helps You

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

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

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2005/06* (product no. 022336kk).

References to Professional Standards. When referring to the professional standards, this Alert cites the applicable sections of the codification and not the numbered statements, as appropriate. For example, SAS No. 54 is referred to as AU section 317 of the AICPA *Professional Standards*.

Economic and Industry Developments

Economic Developments

The U.S. economy proved to be extremely resilient and capable of absorbing the impact of the two major hurricanes that devastated much of the Gulf Coast in August and September of 2005. Despite the hurricanes, real gross domestic product (GDP) grew

3.8 percent in the third quarter, which was above the 3.3 percent growth registered in the second quarter and in line with the first quarter results. However, according to the Securities Industry Association (SIA), despite these positive indicators, signs of weakness have appeared, and 2005 is expected to finish with a real GDP growth of 3.6 percent, which is below last year's level of 4.2 percent. Further deceleration in 2006 is anticipated, as consumers retrench in lagged response to steadily rising interest rates; sharp, sustained increases in fuel costs; and the end of the housing boom. Furthermore, the waning of strong fiscal stimuli and reduced net foreign inflows will further constrain growth. Even so, growth of the U.S. economy is expected to remain above its long-run average of 2.6 percent. For more information, please refer to the November 2005 issue of the SIA Research Report, which can be accessed at www.sia.com/research/pdf/RsrchRprtVol6-10.pdf.

Also, see the AICPA general *Audit Risk Alert—2005/06* for an in-depth discussion of the United States economic and business environment.

The Securities Industry

According to the SIA, for the first half of 2005, profits for all U.S. securities firms doing a public business fell to $8.36 billion, well below the $10.57 billion earned in the first half of last year and the $10.15 billion recorded in the second half. Net revenues, which surged in the final quarter of 2004, fell 6 percent in the first quarter of 2005 and 1.8 percent sequentially in the second quarter. The decline in net revenues reflected the slower growth in revenues and the continued rapid rise in interest expenses due to increases in borrowing rates. Starting in June 2004, the Federal Reserve has raised the Fed Funds rate 12 consecutive times by a quarter of a percentage point from a 45-year-low of 1 percent. As of the time of writing this Alert, the rate stood at 4 percent, but quarter-point increases are expected to continue at the next several Fed meetings.

Net revenue growth resumed in June relative to May and continued to pick up across the third quarter, as primary markets surged and secondary capital market activity remained relatively strong through the normally slow summer season, which helped produce strong third quarter results. New York Stock Exchange (NYSE) share trading volume in the third quarter of 2005 was 15.5 percent above levels in the same year-earlier period, while Nasdaq volume was up 4.3 percent. As a result, commission and fee income in the third quarter slipped only slightly relative to the second quarter levels and remained well above revenues recorded in the third quarter of 2004, as both institutional and retail trading volumes showed surprising strength. Primary markets, normally dormant in late summer, remained active well into mid-August, led by equity underwriting, both domestic and international. Also, revenue growth remained exceptionally strong in the third quarter in prime brokerage, mergers-and-acquisitions (M&A) advisory operations, and at commodities and derivatives desks. The value of announced U.S. mergers and acquisitions in the third quarter was 28.5 percent higher than in the same year-earlier period, while announced global deals jumped 56.9 percent above the third quarter levels of last year. The level of completed deals and the realization of fees during the third quarter of 2005 are believed to have risen even more sharply relative to the same year-earlier period.

The SIA estimates that U.S. securities industry profits reached $6.1 billion in the third quarter and expects even stronger results in the fourth quarter. The forecast for the fourth quarter of 2005 of $6.75 billion would match results in the fourth quarter of 2004 and raise pretax net income for the second half of the year to $12.85 billion. This result, if obtained, would more than offset the weak results for the first half 2005. For the year as a whole, securities industry profits are forecast to reach $21.21 billion, 2.4 percent above the $20.72 billion earned in 2004. Despite the industry's improvements over 2004, 2005's profits will fall 11.8 percent below 2003's profits of $24.05 billion.

For more information, please refer to the September 2005 issue of the SIA Research Report, which can be accessed at www.sia.com/research/pdf/RsrchRprtVol6-9.pdf.

The Commodities Industry

Global futures and options contract volume has continued to increase through 2004 and into 2005. In the first eight months of 2005, volume on U.S. futures exchanges reached 2.25 billion contracts, a 24 percent increase from the same period in 2004. This increase can be attributed primarily to increases in trading volume in interest rate, equity, and energy products. Volume of contracts traded on foreign exchanges increased slightly over 1 percent compared to the first eight months of 2004.

The U.S. futures industry, in addition to the increasing volume, has also experienced other significant changes through 2004 and into 2005. The trend of exchanges toward public ownership continued with the October 2005 initial public offering of shares of CBOT Holdings, Inc., the parent corporation of the Chicago Board of Trade. CBOT Holdings follows the already public parent holding company of the Chicago Mercantile Exchange. At the time of this writing, shares representing a membership at the New York Mercantile Exchange were reported to have been sold privately for a record $3 million, amid increasing speculation of private investment, acquisition, or other capital transactions being considered by its board of directors.

Competition continued in 2005 between futures exchanges, both domestic and foreign, as exchanges continued to offer products that directly compete with established contracts on other exchanges. The New York Mercantile Exchange's opening of an energy trading exchange in the United Kingdom in 2005 is yet another example of the trend toward more aggressive competition and globalization in the industry.

Refco

On October 17, 2005, Refco Inc.,[1] one of the biggest participants in the commodities and financial futures markets, filed for

1. Refco Inc. operated through three main units: Refco LLC, a regulated futures trading unit; Refco Securities, a regulated broker-dealer securities unit; and Refco Capital Markets LTD, an unregulated over-the-counter trading unit. Refco's regulated units were not part of the bankruptcy filing. The discussion in this section primarily applies to the nonregulated entity and not to either the futures commissions merchant or the regulated broker-dealer.

bankruptcy protection, only 10 weeks after its initial public offering (IPO) and just one week after the company revealed its accounting problems. In a public statement issued on October 10, 2005, Refco announced that it had discovered through an internal review a receivable owed to Refco by an entity controlled by the company's then-CEO and chairman of the board in the amount of $430 million, which was not shown as a related party transaction in the company's financial statements. Refco also stated that its financial statements for the years 2002 through 2005 should not be relied on.

On November 10, 2005, Refco's former CEO was indicted for hiding hundreds of millions of dollars in bad debts from auditors and investors. According to the indictment, during the 1990s certain Refco customers to whom Refco had extended credit sustained significant market losses in their Refco accounts. When the customers were unable to make payments on the credit Refco had extended to them, those losses were transferred to a company controlled by Refco's former CEO instead of being written off of Refco's books. The indictment further alleges that this debt, which at one point was as high as $720 million, was hidden from, among others, auditors at the end of annual and quarterly reporting periods by carrying out a series of transactions to temporarily pay down the receivable from the company controlled by Refco's former CEO to unrelated entities. According to the indictment, the fraudulent scheme culminated in Refco's August 2005 IPO in which the public purchased approximately $583 million of Refco stock based on a false and fraudulent registration statement.

This case raises questions about the extent of work performed by external auditors and investment bankers. In the August 2005 SEC filing, Refco disclosed that it was notified by its external auditors in February of deficiencies in its internal controls due to inadequate resources at its finance department, and a "lack of formalized procedures" for closing its books. There is a view that these "red flags" should have led to more work performed by auditors. Others argue that an audit is not an investigation and senior management's involvement in this scheme further reduced the chances of it being uncovered. The fact that this scandal erupted so soon after Refco's IPO also puts a spotlight on the company's investment bankers that oversaw its IPO and whether their due diligence procedures were adequate.

As of the time of writing this publication, Refco case was still unfolding and its implications for the commodities futures industry were not yet clear. Please stay alert to further developments.

Regulatory Issues and Developments[2]

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

The audit and reporting requirements for securities broker-dealers are regulated by Rule 17a-5 under the Securities Exchange Act of 1934 (the Exchange Act). Qualifications and reports of independent accountants of FCMs and IBs are specified by Regulation 1.16 of the Commodity Exchange Act. An alternative regulatory framework has been created for over-the-counter derivatives dealers that establishes a special class of broker-dealers who may choose to register with the SEC under a limited regulatory structure. Further, registered broker-dealers in U.S. government securities

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

are regulated by Section 405.02 of the regulations pursuant to Section 15C of the Exchange Act.

Before undertaking the audit of a regulated entity, auditors should read the applicable rules and understand the prescribed scope of the audit and the related reporting requirements.

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

SEC Passes Regulation National Market System

On April 6, 2005, the Securities and Exchange Commission (SEC) voted to adopt 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).

Order Protection Rule

- Rule 611 requires trading centers to obtain the best price for investors when such price is represented by automated quotations that are immediately accessible.
- Specifically, the rule requires trading centers to establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs, and, if relying on one of the rule's exceptions, which are reasonably designed to assure compliance with the exception.
- The rule protects the best bids and offers of each exchange, Nasdaq, and the NASD's Alternative Display Facility (ADF).
- The rule does not contain a general "opt-out" exception that would have allowed market participants to disregard

displayed quotations. The elimination of any protection for manual quotations is the principal reason that this broad exception is not included in the rule.

- The rule includes a number of exceptions to help ensure that the rule is workable with high-volume stocks and relate to, among others, intermarket sweep orders, quotations displayed by markets that fail to meet the response requirements for automated quotations, and flickering quotations with multiple prices displayed in a single second.
- The rule does not change a broker-dealer's existing duty to obtain best execution for customer orders.

Intermarket Access

- Rule 610 establishes a uniform market access rule that will promote nondiscriminatory access to quotations displayed by self-regulatory organization (SRO) trading centers through a private linkage approach.
- Rule 610 also harmonizes the pricing of quotations across different trading centers by limiting the fees that any trading center could charge for accessing protected quotations or manual quotations that are at the best bid or offer, to no more than $0.003 per share (or, if the price of a protected quotation is less than $1.00, to no more than 0.3 percent of the quotation price per share).
- Finally, the rule requires each SRO to establish and enforce rules that, among other things, prohibit its members from engaging in a pattern or practice of displaying quotations that lock or cross the protected quotations of other trading centers.

Sub-Penny Pricing

- Rule 612 prohibits market participants from displaying, ranking, or accepting quotations in NMS stocks that are priced in an increment of less than $0.01, unless the price of the quotation is less than $1.00. If the price of the quotation is less than $1.00, the minimum increment would be $0.0001.

- This rule is intended to prevent sub-penny pricing from being used to “step ahead” of customer limit orders for an economically insignificant amount that could, over time, discourage investors from placing limit orders, an important source of market liquidity.

Market Data

- Regulation NMS updates the formulas for allocating revenues generated by market data fees to the various SROs to correct the flaws of the current formulas, which incent distortive behavior such as wash sales and trade shredding, and to allocate revenues to SROs that contribute to public price discovery by dividing market data revenues equally between trading and quoting activity.

- The amendments also require the SRO committees governing the market data consolidation systems to create advisory committees composed of non-SRO representatives to the joint industry plans. The advisory committees are intended to improve the transparency and effective operation of the plans by broadening participation in plan governance.

- Finally, the rule promotes the wide availability of market data by authorizing markets to distribute their own data independently (while still providing their best quotations and trades for consolidated dissemination through the plans) and streamlining requirements for the display of market data to investors.

As part of the final rules release under Regulation NMS (Release No. 34-51808), the SEC also adopted two amendments to the joint industry plans for disseminating market information that modify the formulas for allocating plan revenues and broaden participation in plan governance.

Subsequent to the issuance of the final rules on June 9, 2005, the SEC extended compliance dates for Rule 612 from August 29, 2005, to January 31, 2006, and for amended Rule 301(b)(5) from August 29, 2005, to September 28, 2005. Please refer to www.sec.gov/rules/final/34-52196.pdf and www.sec.gov/rules/final/34-52355.pdf for more information.

The full text of the rules can be accessed at www.sec.gov/rules/final/34-51808.pdf.

SEC Approves Final Rule Regarding Certain Broker-Dealers Deemed Not to Be Investment Advisers

In April 2005, the SEC adopted a rule addressing the application of the Investment Advisers Act of 1940 to broker-dealers offering certain types of brokerage programs. Under the rule, a broker-dealer providing advice that is solely incidental to its brokerage services is excepted from the Advisers Act if it charges an asset-based or fixed fee (rather than a commission, mark-up, or mark-down) for its services, provided it makes certain disclosures about the nature of its services. The rule states that exercising investment discretion is not "solely incidental to" (1) the business of a broker or dealer within the meaning of the Advisers Act or (2) brokerage services within the meaning of the rule. The rule also states that a broker or dealer provides investment advice that is not solely incidental to the conduct of its business as a broker or dealer or to its brokerage services if the broker or dealer charges a separate fee or separately contracts for advisory services. In addition, the rule states that when a broker-dealer provides advice as part of a financial plan or in connection with providing planning services, a broker-dealer provides advice that is not solely incidental if it (1) holds itself out to the public as a financial planner or as providing financial planning services, (2) delivers to its customer a financial plan, or (3) represents to the customer that the advice is provided as part of a financial plan or financial planning services. Finally, under the rule, broker-dealers are not subject to the Advisers Act solely because they offer full-service brokerage and discount brokerage services (including electronic brokerage) for reduced commission rates.

The rule became effective on April 15, 2005, with certain exceptions. In September 2005, the SEC extended the compliance date from October 24, 2005, to January 31, 2006, for the rule that identifies circumstances under which a broker-dealer's advice is not "solely incidental to" its brokerage business or to brokerage services provided to certain accounts and thus subjects the broker-dealer to the Investment Advisers Act of 1940. See Releases No. 34-51523 and No. 34-52407 for full text of the complete rule as well as the compliance and effective date information.

Supervisory Controls and Annual Compliance Certification

Last year NASD and NYSE issued rules and rule amendments addressing supervisory controls and related compliance certification, some of which became effective in 2005.

NASD Rules

NASD Rule 3012. On September 30, 2004, the SEC approved NASD's Supervisory Control Amendments in their final form. A fundamental element of the Supervisory Control Amendments is new Rule 3012, *Supervisory Control System*. Rule 3012(a)(1) requires a member to designate one or more principals who will establish, maintain, and enforce a system of supervisory control policies and procedures that tests and verifies that a member's supervisory procedures are reasonably designed to comply with applicable securities laws and regulations, and with applicable NASD rules, and to amend those supervisory procedures when the testing and verification demonstrate a need to do so. The Rule also requires the designated principal or principals to submit to the member's senior management no less than annually a report detailing each member's system of supervisory controls, the summary of the test results and significant identified exceptions, and any additional or amended supervisory procedures created in response to the test results.

Rule 3012 became effective on January 31, 2005, which would require a member's first Rule 3012 report to be submitted by no later than January 31, 2006, and at least annually thereafter.

However, in October 2005, NASD amended Rule 3012 to extend until April 1, 2006, the date by which members must submit their initial annual report required by that rule. Please refer to NASD Notice to Members 05-75 for more information.

NASD Rule 3013. On September 10, 2004, the SEC approved new NASD Rule 3013, *Annual Certification of Compliance and Supervisory Processes*, and accompanying interpretive material that requires members to (1) designate a chief compliance officer (CCO) and (2) have the CEO or equivalent officer certify annually that the member has in place processes to establish, maintain, review, test, and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable NASD rules, Municipal Securities Rulemaking Board (MSRB) rules, and federal securities laws and regulations.

Rule 3013 became effective on December 1, 2004, which would require a member's first certification to be executed by December 1, 2005 and annually thereafter. However, in October 2005, NASD amended Rule 3013 to extend until April 1, 2006, the date by which members must execute their first annual certification pursuant to that rule. Please refer to NASD Notice to Members 05-75 for more information.

NYSE Rules

On June 17, 2004, the SEC approved amendments to NYSE Rule 342, *Offices—Approval, Supervision and Control*, to strengthen the supervisory procedures and internal controls of members and member organizations. These amendments became effective on December 17, 2004. The amended Rule 342 includes a new requirement that members and member organizations establish procedures to independently verify and test the supervisory systems over each of their business activities. NYSE Rule 342 closely tracks NASD Rule 3012.

On August 12, 2005, the NYSE filed with the SEC an amendment to Rule 342.30, *Annual Compliance Reports*, which would, among other things, require each member and the CEO of each member organization to file a yearly statement confirming the adequacy of their compliance processes and procedures. This requirement closely resembles the certification requirement of NASD Rule 3013. The comment period expired on September 12, 2005.

Additional Guidance

With the approach of the deadline for the initial NASD Rule 3013 CEO Compliance Certification, firms are evaluating their readiness to meet the requirements of this rule and related NASD Rule 3012. In addition, NYSE member firms also have to comply with NYSE Rule 342. Readers may wish to refer to the following guidance issued by SROs to help their members and member firms comply with the new and amended rules:

- NASD Notice to Members 05-75, *Amendments Regarding Deadlines for Submission of Initial Annual Report under Rule 3012 and Execution of the Initial Annual Certification under Rule 3013 and IM-3013*
- NASD Notice to Members 05-29, *Guidance Regarding Rule 3012(a)(1) Requirement to Test and Verify a Member's Supervisory Policies and Procedures*
- NASD Notice to Members 05-08, *Guidance Regarding the Application of the Supervisory Control Amendments to Members' Securities Activities, Including Members' Institutional Securities Activities*
- NASD Notice to Members 04-79, *SEC Approves New Chief Executive Officer Compliance Certification and Chief Compliance Officer Designation Requirements*
- NASD Notice to Members 04-71, *SEC Approves New Rules and Rule Amendments Concerning Supervision and Supervisory Controls*
- NYSE Information Memo 04-38, *Amendments to Rules 342, 401, 408 and 410 Relating to Supervision and Internal Controls*

Rulemaking Regarding Responsibility When Outsourcing Activities to Third-Party Service Providers

NYSE Proposed Rule

On March 16, 2005, the NYSE filed with the SEC a proposed new Rule 340, which would govern conditions to be satisfied in connection with outsourcing arrangements between members and member organizations and various service providers.

The concept of outsourcing is not new to the securities industry. NYSE Rule 382 has long permitted introducing broker-dealers to contractually delegate functions and responsibilities to clearing broker-dealers. Typically introducing firms agree to retain responsibility for the opening, approving, and monitoring of accounts and delegate to clearing firms "back office" functions such as order execution and clearance of trades. Since Rule 382 allows for the delegation of both functions *and* responsibilities to a clearing firm, it requires that any agreement made pursuant to its provisions be subject to the prior review and approval of the Exchange, and be limited to registered broker-dealers. Over the past several years, the outsourcing of services has extended beyond arrangements between registered broker-dealers. It is not uncommon to now find outsourcing arrangements between broker-dealers and other types of regulated and unregulated entities. Different outsourcing arrangements have given rise to different types of regulatory concerns.

Proposed Rule 340A prohibits members and member organizations from outsourcing certain functions. Specifically, except as otherwise permitted by the Exchange, it would prohibit members and member organizations from delegating, contracting, or outsourcing to any service provider supervisory or compliance responsibilities under Exchange Act Rule 342, as well as activities that require registration and qualification under the Exchange rules. These proposed restrictions reinforce the long-held concept that functions can be outsourced but responsibility cannot.

For a full text of the proposal, please refer to www.nyse.com/pdfs/2005-22fil.pdf.

NASD Notice to Members

In July 2005, NASD issued Notice to Members 05-48, *Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers*, to remind members that, in general, any parties conducting activities or functions that require registration under NASD rules will be considered associated persons of the member, absent the service provider separately being registered as a broker-dealer and such arrangements being contemplated by NASD rules (such as in the case of clearing arrangements), MSRB rules, or applicable federal securities laws or regulations. In addition, outsourcing an activity or function to a third party does not relieve members of their ultimate responsibility for compliance with all applicable federal securities laws and regulations and NASD and MSRB rules regarding the outsourced activity or function. As such, members may need to adjust their supervisory structure to ensure that an appropriately qualified person monitors the arrangement. This includes conducting a due diligence analysis of the third-party service provider.

Additional Guidance

On February 15, 2005, the Bank for International Settlements released a Joint Forum publication, *Outsourcing in Financial Services*, regarding principles of outsourcing in financial services. The rapid rate of IT innovation, along with an increasing reliance on external service providers, have the potential of leading to systemic problems unless appropriately constrained by a combination of market and regulatory influences.

This paper attempts to spell out these concerns in more detail and develop a set of principles that gives guidance to firms, and to regulators, to help them better mitigate these concerns without hindering the efficiency and effectiveness of firms. This paper can be found at www.bis.org/publ/joint12.htm.

Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities

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." 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, recordkeeping, reporting, and certain other requirements, and must implement and document an internal risk management system. This alternative method is available to broker-dealers that maintain tentative net capital of at least $1 billion and net capital of at least $500 million. Furthermore, as a condition to its use of the alternative method, the 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. These rule amendments became effective on August 20, 2004. See SEC Release No. 34-49830 at www.sec.gov/rules/final/34-49830.htm for more information.

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 SEC 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. 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. The agreed-upon procedures should be performed and the report should be prepared in accordance with the rules promulgated by the Public Company Accounting Oversight Board (PCAOB). While the specifics have yet to be finalized, the external auditors' annual agreed upon-procedures can be developed to limit redundancies with the internal audit function's requirement to review these same controls on a periodic basis.

Also, under this alternative method, firms with strong internal risk management practices may use mathematical modeling methods already used to manage their own business risk, including value-at-risk (VaR) models and scenario analysis, for regulatory purposes. SEC Rule 15c3-1e(d)(1)(ii) requires that the VaR model be reviewed both periodically and annually. The periodic review may be conducted by the broker-dealer's internal audit staff, but the annual review must be conducted by the external auditor. External auditors will need to evaluate these VaR models in rendering their report on the supplemental schedules required under Rule 15c3-1 of the Securities Exchange Act of 1934 that is included in the annual audited financial statements of the broker dealer.

Furthermore, the consolidated entity must disclose its compliance with the capital requirements at the consolidated group level (most likely in the notes to the Annual Report), and in turn the external auditor must review the VaR models used in this separate computation.

The Stockbrokerage Expert Panel of the AICPA is in the process of developing audit guidance to be included in next year's update to the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* to provide guidance to broker-dealers and public accounting firms in connection with these requirements.

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

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

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

The Act establishes a deadline for registration with the PCAOB of auditors of financial statements of "issuers." The Act does not provide a deadline for registration of auditors of nonpublic broker-dealers. Application of registration requirements and procedures to auditors of nonpublic broker-dealers is still being considered. The SEC is also considering whether to issue a concept release on the subject.

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. The original Order, issued on August 4, 2003, and extended on July 14, 2004, was set to expire on January 1, 2006.

See Release No. 34-52909 at www.sec.gov/rules/other/34-52909.pdf for more information.

Recent Developments in Connection With Breakpoint Refund Liability

In Notice to Members 03-47, *Refunds to Customers Who Did Not Receive Appropriate Breakpoint Discounts in Connection with the Purchase of Class A Shares of Front-End Load Mutual Funds and the Capital Treatment of Refund Liability*, issued in August 2003, NASD ordered broker-dealers to provide refunds to customers who had not been given appropriate breakpoint discounts on purchases of mutual funds with front-end loads. Mutual funds sold through broker-dealers may include a sales charge (also called a *load*), which compensates the broker-dealer selling the fund's shares. Mutual funds with front-end sales loads often offer investors the opportunity to obtain a reduction in sales loads as the dollar value of the shares purchased by an investor or a member of his or her family increases. The levels at which the front-end sales charge is reduced are determined by the mutual funds and are generally called *breakpoints*. Although breakpoint discounts are offered by mutual funds, much of the responsibility for calculating the proper discounts falls on the participating brokerage firms, pursuant to contractual selling arrangements.

In Notice to Members 03-47, NASD provided guidelines for firms to follow when calculating refunds to customers and accounting for their anticipated refund liabilities. NASD stressed that firms needed to consider the requirements of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, when accounting for their refund liability. FASB Concept Statement No. 6 specifically recognizes that the amount of a liability does not need to be certain before it is recorded. Accordingly, approximations and estimates may be used to record a liability. Thus, firms had to determine their probable liability based upon information available at the time in accordance with FASB Concept Statement No. 6. NASD also issued further guidance to members based on a result of a survey, as to the amount of refund they should be setting aside for customers. Firms were either to record this amount or justify the appropriateness of selecting an alternative amount.

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

Yet based on their experiences to date, a number of broker-dealers have claimed that they were overly conservative in estimating the total amount of potential customer restitution. Presumably, many customers who likely or possibly failed to receive breakpoint discounts have not submitted claims. Accordingly, these firms believe that due to the passage of time and in light of their efforts to communicate the availability of a possible refund, it is appropriate to reverse fully or reduce their remaining liability related to such restitution.

Presently, NASD will review and consider any firm's request to reduce or remove any liability related to a failure to provide breakpoint discounts. Firms will need to provide NASD with a substantive and well-reasoned explanation and argument about why the recognition of the liability is no longer necessary and its reversal or reduction would not make the firm's financial statements misleading.

Asset Services

SEC Examination

The SEC staff recently completed a series of five examinations that were conducted for the purpose of comprehensively reviewing the asset services activities of various broker-dealer firms. Asset services include those activities of the broker-dealer related to the timely and accurate disbursement of dividends, interest, and principal payments; the collection of offsetting amounts from issuers; and the performance of various corporate reorganization-related services, including, but not limited to, the processing of bond calls, redemptions, tender offers, and warrant and rights exercises. Asset services also include the procedures whereby unclaimed assets are escheated to the appropriate governmental authority. The purpose of these examinations was to determine whether the broker-dealers were carrying out their asset services activities in an accurate, timely, and efficient manner. The periods reviewed generally included the years 2002 and 2003.

Examination Findings

The examinations disclosed a variety of deficiencies, including a consistent failure to properly supervise the asset services functions; a lack of adequate written procedures in certain asset services areas, particularly with respect to escheatment; and a widespread failure to enforce the procedures that the registrant did have. In addition, there appears to have been a systemic misuse of suspense and other accounts in connection with the dispositions of abandoned customer assets. Most of the examinations disclosed that the registrant had been improperly transferring abandoned customer assets at will into, out of, and between various accounts, including suspense, expense, income and proprietary accounts, resulting in the improper use of customer assets, as well as inaccurate books and records. Although this was generally limited to accounts with less substantial holdings, these actions by the broker-dealers were nevertheless frequently used to increase their income by, for example, the reduction of expenses. Several of the examinations disclosed that the firm had entirely failed to escheat certain assets, sometimes over a period lasting many years. Inaccurate books and records, as well as inaccurate net capital computations and FOCUS filings, which were caused by the improper account entries, were also uncovered.

Audit Response

Auditors should keep in mind the above findings when conducting audits of their broker-dealer clients. The auditor should review the procedures followed by the broker-dealer for recording material transactions in accounts for unclaimed customer assets. Also, 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 and test the broker-dealer's procedures for abandoned property accounts and compliance with state escheat laws. Auditor should also ensure that procedures for monitoring and resolving customer complaints are adequate.

The auditor should ensure that the broker-dealer's controls regarding procedures for researching and resolving items in suspense accounts on a timely basis are sufficient. To achieve this audit objective, the auditor should consider performing the following tests:

- Determine the appropriateness of procedures for recording transactions into suspense accounts:
  - 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.

From a regulatory standpoint, the auditor needs to consider whether unclaimed assets are appropriately reflected in the supporting schedules described in the Exchange Act Rule 17a-5(d)(3) with respect to the reserve and possession or control requirements of Exchange Act Rule 15c3-3.

Recent Concerns of Regulators

Over the past several years during examinations of broker-dealers, NASD encountered a number of issues, some of which are discussed in this section.

Soft Dollar and Commission Rebate and Recapture Arrangements

A number of broker-dealers offer some type of soft dollar or commission rebate and recapture program. While the nature of the benefits to customers involved in such programs vary, the mechanics of the payments can substantially increase a broker-dealer's net capital requirement pursuant to the Securities Exchange Act Net Capital Rule, and may subject the broker-dealer to the requirements of the Securities Exchange Act Customer Protection Rule. NASD has encountered situations in which a broker-dealer will claim to be offering a soft dollar program—where presumably the broker-dealer arranges for the provision of a service or product to a customer, independently of the customer—when, in fact, the structure of the remittance to a third party amounts to a commission rebate. Firms should be aware that the primary guidance regarding financial requirements relative to the use of commission rebate and recapture arrangements is found in a February 2002 verbal interpretation from the SEC to the New York Stock Exchange, which is as follows:

> Any introducing broker-dealer that rebates a portion of its commission back to its customer, either as a cash payment or to a

creditor of the customer, is required by SEC Rule 15c3-1(a)(2)(i) to maintain a minimum net capital requirement of at least $250,000. It is also considered a carrying firm for purposes of SEC Rule 15c3-3 unless it elects the following method for the handling of the customers' rebates:

(1) The introducing broker deposits money into a separate SEC Rule 15c3-3 bank account similar to those accounts established under an SEC Rule 15c3-3(k)(2)(i) exemption;

(2) The balance in this separate bank account at all times must equal or exceed the payables to customers; and

(3) The firm issues checks from this separate bank account to pay the customer or the creditor of the customer.

NASD plans to issue a Notice to Members that would provide additional guidance relative to the regulatory financial requirements that could stem from such programs and illustrate the differences between what is viewed as a soft dollar arrangement as opposed to a commission rebate and recapture program.

Transfers or "Sweeps" of Customer Free Credit Balances to Other Locations and Into Other Investments

With the increasing popularity of "sweeps" programs for customers' credit balances, the NASD is concerned with (1) the sufficiency and timeliness of the broker-dealer's communication with its customers with respect to such arrangements and (2) in some cases, the passage of "swept funds" through a number of "hands" before being invested. With the current increases in short-term interest rates relative to long-term rates, NASD anticipates seeing a wider use and a greater variety of "sweep" programs, which may include participants and investees that are either contractually not accountable or lack the experience, systems, and controls to appropriately account for customer funds. At this time, NASD recommends that broker-dealers become *thoroughly* familiar with the issues addressed in the New York Stock Exchange's Information Memorandum 05-11, *Customer Account Sweeps to Banks*, which is discussed in the "Self-Regulatory Organization Regulations" section of this Alert under the "NYSE Rulemaking" heading.

Appropriate Valuation of and Application of Net Capital Charges With Respect to Asset-Backed Securities

Occasionally, NASD has come across instances of a broker-dealer that routinely acquires substantial portions of an outstanding issuance of an asset-backed security, and internally determines the fair value of the position. In these situations, the broker-dealer will often assert to its clearing firm that this "fair value" is reasonably accurate and should be used to price the position held at the clearing firm. A clearing firm may acquiesce to the broker-dealer's view, and include on the client's statement a note indicating that it used a price that was supplied by the broker-dealer and did not independently verify the reasonableness of the price.

NASD will question and may disallow for net capital purposes the value of any security that the broker-dealer priced internally and without collaboration in the marketplace, especially if the firm does not appear to be a market participant with other broker-dealers for similar securities. Firms and independent auditors are encouraged to contact NASD with any questions regarding appropriate pricing practices relative to any security positions that contribute materially to a firm's net capital.

While NASD plans to publish a comprehensive interpretation dealing with the net capital charges related to collateralized mortgage obligations, broker-dealers should seek guidance in determining the appropriate net capital charges related to any asset-backed securities by reviewing the following No-Action Letters (each addressed to the Capital Committee of the Securities Industry Association):

- *Marketability of Asset-Backed Securities Issued by Special Purpose Vehicles*, dated July 13, 2001, and as applicable relative to an additional portfolio charge, *Portfolio Concentration Charges for Certain Securities Under Rule 15c3-1 of the Securities Exchange Act of 1934*, dated July 27, 2000

- If the issuer of the asset-backed security is an *operating* entity, *Net Capital Treatment of Single Rated Investment Grade Asset-Backed Debt Securities*, dated August 6, 1999

As these letters are *not* readily accessible, readers may call NASD at (202) 728-8397 to obtain a copy.

Application of Appropriate Haircut Charges to All Positions Recorded as Long or Short Inventory Regardless of Location

Currently, the SEC Division of Market Regulation requires broker-dealers to apply market risk charges (haircuts) to their recognized securities inventory pursuant to the Net Capital Rule, regardless of the location of inventory positions. For instance, an acquired inventory position that served as collateral to a repurchase transaction would be subject to the haircut provisions. In addition, the repurchase transaction would be subject to credit risk charge provisions pursuant to the Net Capital Rule. Certain broker-dealers have contended that the market risk element related to the collateral had been transferred to the counter-party of the repurchase transaction, and consequently, the broker-dealer's risk is related primarily to the receipt of any marks-to-the-market from the counterparty, that is, what is at issue is credit risk and the broker-dealer's ability to minimize any "unsecured receivable" relative to the collateral. In Securities Release 34-24553, issued June 4, 1987, to amend net capital, recordkeeping, and quarterly securities count rules in connection with the treatment of repurchase and reverse repurchase agreements, the Division of Market Regulation considered the issue of applying a market risk and credit risk relative to the same underlying position. In footnote 13 of the Release, the Division of Market Regulation staff indicated:

> The Commission recognizes that when a broker-dealer enters into repurchase agreements using proprietary securities, the firm may incur a deduction because of a repo deficit and a deduction, or haircut, related to the securities. The Commission also understands that it is difficult for broker-dealers that engage in a significant amount of repurchase transactions to identify the specific securities that were used in a particular repurchase agreement. For those broker-dealers that believe they have a program which can specifically identify those proprietary securities which are used in a particular repurchase agreement, the Commission will entertain requests for no-action

positions that would allow any repurchase agreement deficit deduction to be reduced by the haircut already incurred with respect to the repurchase agreement securities.

Inclusion of Customer Funds Held as a Result of Over-the-Counter Derivative Transactions as Credits in the Reserve Formula

In certain instances, broker-dealers that engage in over-the-counter commodity transactions with customers, and are not registered as over-the-counter derivative dealers, have questioned whether customer margin or "transaction performance" deposits need to be included as credits in the Customer Protection Reserve Formula. Based on a discussion of the Reserve formula components in one of the adoptive releases to the Customer Protection Rule (Securities Exchange Act Release 34-9922, dated January 2, 1973), the SEC indicated that "net balances due to customers in nonregulated commodity accounts, reduced by any deposits of cash or securities with any clearing organization or clearing broker in connection with open contracts in such accounts" are to be included as customer credits in the formula.

NASD has encountered instances in which broker-dealers, which are not registered as over-the-counter derivative dealers, have excluded cash balances related to open commodity derivative transactions, asserting that the Securities Investor Protection Act does not protect such balances. NASD believes that in light of the current interpretative guidance and the specific language included in the definition of customer regarding transactions conducted by registered over-the-counter derivative dealers, customer cash balances held by broker-dealers which are not registered as over-the-counter derivative dealers related to commodity transactions must be included as customer credits.

Appropriateness of Amounts Added Back to Owners' Equity in Computing Net Capital Related to Nonsubstantive or Discretionary Liabilities

Certain firms have concluded that nonsubstantive liabilities—those that will not require a future transfer of cash or assets, such as deferred tax liabilities related to financial reporting and tax bases differences of acquired intangible assets—can be added back to owners' equity in computing net capital. These firms also assert that since the underlying asset is nonallowable, the related liability should not act as a further reduction in deriving net capital. Based on NASD's discussions with the SEC Division of Market Regulation staff, any add-back of deferred tax liabilities to owner's equity in computing net capital must result from those transactions discussed in published interpretations. Currently, such transactions must relate to the capitalization of internally developed software or deferred advertising costs. The SEC Division of Market Regulation staff will consider requests for relief relative to specific transactions that result in the recognition in deferred tax liabilities and do not entail any compensatory increase in revenue.

NASD also encounters the add-back of what are considered discretionary liabilities. Please refer to the "Discretionary Liabilities" section of this Alert for a discussion of NASD requirements in connection with this issue.

SEC Regulations

Certain SEC regulations are discussed in the preceding sections of this Alert in detail due to the significance of their impact on broker-dealers. The following is a summary of some additional rules that the SEC issued since the writing of last year's Audit Risk Alert that may be of interest to broker-dealers. In addition to reading about the regulatory matters presented below, see the AICPA general *Audit Risk Alert—2005/06* and the AICPA *Independence and Ethics Alert—2005/06* for a discussion of some of the most important SEC regulations that have been issued recently that affect many industries, including the securities industry. Also, auditors should visit the SEC Web site at www.sec.gov to inform themselves about recent SEC rulemaking activities.

- *Securities Offering Reform*. In July 2005, the SEC adopted rules that will modify and advance significantly the registration, communications, and offering processes under the Securities Act of 1933. These rules will eliminate unnecessary and outmoded restrictions on offerings. In addition, the rules will provide more timely investment information to investors without mandating delays in the offering process that would be inconsistent with the needs of issuers for timely access to capital. The rules also will continue SEC long-term efforts toward integrating disclosure and processes under the Securities Act and the Securities Exchange Act of 1934. The rules will further these goals by addressing communications related to registered securities offerings, delivery of information to investors, and procedural aspects of the offering and capital formation processes. Effective date: December 1, 2005. See Release No. 33-8591 for more information.

- *Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies*. In July 2005, the SEC adopted rules and rule amendments relating to filings by reporting shell companies. The SEC defined a *shell company* as a registrant with no or nominal operations and either no or nominal assets, assets consisting solely of cash and cash equivalents, or assets consisting of any amount of cash and cash equivalents and nominal other assets. The rules and rule amendments prohibit the use of Form S-8 under the Securities Act of 1933 by shell companies. In addition, they require a shell company that is reporting an event that causes it to cease being a shell company to disclose the same type of information that it would be required to provide in registering a class of securities under the Securities Exchange Act of 1934. These provisions are intended to protect investors by deterring fraud and abuse in the securities markets through the use of reporting shell companies. Effective date: August 22, 2005, with certain exceptions. See Release No. 33-8587 for more information.

- *Removal from Listing and Registration of Securities Pursuant to Section 12(d) of the Securities Exchange Act of 1934*. In July 2005, the SEC adopted amendments to its rules and Form 25 to streamline the procedures for removing from listing, and withdrawing from registration, securities under Section 12(b) of the Exchange Act. The final rules require all issuers and national securities exchanges seeking to delist and/or deregister a security in accordance with the rules of an exchange and the SEC to file the amended Form 25 in an electronic format with the SEC on the EDGAR database. The final rules also provide that the Form 25 serves as an exchange's notice to the SEC under Section 19(d) of the Exchange Act. Finally, the final rules exempt, on a permanent basis, standardized options and security futures products traded on a national securities exchange from Section 12(d) of the Exchange Act. The amendments serve to reduce regulatory burdens on the exchanges and issuers, and to make the delisting and deregistration process more transparent and efficient in the interests of investors and the public. Effective date: August 22, 2005. See Release No. 34-52029 for more information.

- *Amendments to the Penny Stock Rules*. In July 2005, the SEC amended the definition of *penny stock* as well as the requirements for providing certain information to penny stock customers. These amendments are designed to address market changes, evolving communications technology, and legislative developments. Effective date: September 12, 2005. See Release No. 34-51983 for more information.

- *Mutual Fund Redemption Fees*. In March 2005, the SEC adopted a new rule that allows registered open-end investment companies (funds) to impose a redemption fee, not to exceed 2 percent of the amount redeemed, to be retained by the fund. The redemption fee is intended to allow funds to recoup some of the direct and indirect costs incurred as a result of short-term trading strategies, such as market timing. The new rule also requires most funds to enter into written agreements with intermediaries (such as broker-dealers and retirement plan administrators) that hold shares on behalf of other investors, under which the intermediaries must agree to provide funds with certain shareholder identity and transaction information at the request of the fund and carry out certain instructions from the fund. Effective date: May 23, 2005 with some exceptions. Compliance date: October 16, 2006, with some exceptions. See Release No. IC-26782 for more information.

- *XBRL Voluntary Financial Reporting Program on the EDGAR System*. In February 2005, the SEC adopted rule amendments to enable registrants to submit voluntarily supplemental tagged financial information using the eXtensible Business Reporting Language (XBRL) format as exhibits to specified EDGAR filings under the Securities Exchange Act of 1934 and the Investment Company Act of 1940. Registrants choosing to participate in the voluntary program also will continue to file their financial information in HTML or ASCII format, as currently required. To participate in the program, volunteers need to submit their XBRL formatted information in accordance with the amendments. Effective date: March 16, 2005. See Release No. 33-8529 for more information.

- *Asset-Backed Securities*. In December 2004, the SEC adopted new and amended rules and forms to address comprehensively the registration, disclosure, and reporting requirements for asset-backed securities under the Securities Act of 1933 and the Securities Exchange Act of 1934. The final rules and forms accomplish the following: update and clarify the Securities Act registration requirements for asset-backed securities offerings, including expanding the types of asset-backed securities that may be offered in delayed primary offerings on Form S-3; consolidate and codify existing interpretive positions that allow modified Exchange Act reporting that is more tailored and relevant to asset-backed securities; provide tailored disclosure guidance and requirements for Securities Act and Exchange Act filings involving asset-backed securities; and streamline and codify existing interpretive positions that permit the use of written communications in a registered offering of asset-backed securities in addition to the statutory registration statement prospectus. Effective date: March 8, 2005.

See Release No. 33-8518 for compliance date and other information.

- *Disposal of Consumer Report Information*. In December 2004, the SEC adopted amendments to the rule under Regulation S-P requiring financial institutions to adopt policies and procedures to safeguard customer information. The amended rule implements the provision in section 216 of the Fair and Accurate Credit Transactions Act of 2003 requiring proper disposal of consumer report information and records. Section 216 directs the SEC and other federal agencies to adopt regulations requiring that any person who maintains or possesses consumer report information or any compilation of consumer report information derived from a consumer report for a business purpose must properly dispose of the information. The amendments also require the policies and procedures adopted under the safeguard rule to be in writing. Effective date: January 11, 2005. See Release No. 34-50781 for compliance date and other information.
- *Issuer Restrictions or Prohibitions on Ownership by Securities Intermediaries*. In December 2004, the SEC adopted a new rule under the Securities Exchange Act of 1934 that prohibits registered transfer agents from effecting any transfer of any equity security registered under Section 12 or any equity security that subjects an issuer to reporting under Section 15(d) of the Exchange Act if such security is subject to any restriction or prohibition on transfer to or from a securities intermediary, such as clearing agencies, banks, or broker-dealers. The primary purpose of the rule is to promote the integrity and efficiency of the U.S. clearance and settlement system. Effective date: March 7, 2005. See Release No. 34-50758A for more information.

Other Recent SEC Developments

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

SEC Interpretive Releases[3]

Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934. On October 19, 2005, the SEC published for comment interpretive guidance on money managers' use of client commissions to pay for brokerage and research services under Section 28(e) of the Securities Exchange Act of 1934. Section 28(e) creates a "safe harbor" by providing that a person who exercises investment discretion with respect to an account shall not be deemed to have acted unlawfully or to have breached a fiduciary duty under state or federal law solely by reason of having caused an account to pay more than the lowest available commission if that person determines in good faith that the amount of the commission is reasonable in relation to the value of the "brokerage and research services" received.

The proposed interpretive guidance interprets the scope of the safe harbor as follows:

- Eligibility of brokerage and research services for safe harbor protection is governed by the criteria in Section 28(e)(3), consistent with the Commission's 1986 "lawful and appropriate assistance" standard.
- *Research services* are restricted to "advice," "analyses," and "reports" within the meaning of Section 28(e)(3).
- Physical items, such as computer hardware, which do not reflect the expression of reasoning or knowledge relating to the subject matter identified in the statute, are outside the safe harbor.
- Market, financial, economic, and similar data would be eligible for the safe harbor.
- *Brokerage services* within the safe harbor are those products and services that relate to the execution of the trade from

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

the point at which the money manager communicates with the broker-dealer for the purpose of transmitting an order for execution, through the point at which funds or securities are delivered or credited to the advised account.

- Mixed-use items must be reasonably allocated between eligible and ineligible uses, and the allocation must be documented so as to enable the money manager to make the required good faith determination of the reasonableness of commissions in relation to the value of brokerage and research services.

This release reiterates the statutory requirement that money managers must make a good faith determination that commissions paid are reasonable in relation to the value of the products and services provided by broker-dealers in connection with the managers' responsibilities to the advisory accounts for which the managers exercise investment discretion.

Finally, the release reiterates that under Section 28(e), broker-dealers must be financially responsible for the brokerage and research products that they provide to money managers, and they must be involved in "effecting" the trade.

Comments should be received on or before November 25, 2005. Please see Release No. 34-52635 for more information.

Commission Guidance Regarding Prohibited Conduct in Connection With IPO Allocations. On April 7, 2005, the SEC issued an interpretive release to provide guidance regarding prohibited conduct by underwriters in connection with IPO allocations. Regulation M prohibits underwriters and others from bidding for, purchasing, or attempting to induce any person from bidding for or purchasing an offered security during a restricted period as defined in Regulation M. Generally, the restricted period begins one or five business days before the determination of an offering price and ends upon a person's completion of participation in the distribution. The guidance serves as a reminder that attempts to induce aftermarket purchases during a restricted period are prohibited by Regulation M. Attempts to induce aftermarket bids or purchases undermine the integrity of the market as an independent pricing mechanism and give prospective IPO purchasers the impression that there is a scarcity of the offered securities and the balance of their buying interest can only be satisfied in the aftermarket. Moreover, other investors who purchase shares in the aftermarket would not know that aftermarket demand had been stimulated by the underwriter's unlawful conduct. The guidance includes references to recent SEC enforcement cases alleging inducements in the offering process in violation of Regulation M. The guidance also discusses distinctions between conduct that violates Regulation M and legitimate book-building. Effective date of interpretation: April 7, 2005. See Release No. 33-8565 for more information.

SEC Special Studies[4]

Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers. On June 15, 2005, the SEC released a staff report on off-balance sheet arrangements, special purpose entities (SPEs), and related issues that was prepared pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002. The staff report includes an analysis of the filings of issuers as well as an analysis of pertinent U.S. generally accepted accounting principles and SEC disclosure rules. The report describes the staff's study, details its findings, and provides recommendations.

The staff took a broad approach to the scope of the report by including a review of a range of topics with potential off-balance sheet implications, including consolidation issues, transfers of financial assets with continuing involvement, retirement arrangements, contractual obligations, leases, contingent liabilities and derivatives, as well as a discussion of SPEs.

The report identifies several goals for those involved in the financial reporting community, including efforts to:

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

- Discourage transactions and transaction structures motivated primarily and largely by accounting and reporting considerations, rather than economics;
- Expand the use of objectives-oriented standards;
- Improve the consistency and relevance of disclosures; and
- Focus financial reporting on communication with investors, rather than just compliance with rules.

The report also provides recommendations for certain changes in accounting and reporting requirements, each of which complement one or more of the goals mentioned above:

- The accounting guidance for defined-benefit pension plans and other postretirement benefit plans should be reconsidered. The trusts that administer these plans are currently exempt from consolidation by the issuers that sponsor them, effectively resulting in the netting of assets and liabilities in the balance sheet. In addition, issuers have the option to delay recognition of certain gains and losses related to the retirement obligations and the assets used to fund these obligations.
- The accounting guidance for leases should be reconsidered. The current accounting for leases takes an "all or nothing" approach to recognizing leases on the balance sheet. This results in a clustering of lease arrangements such that their terms approach, but do not cross, the "bright lines" in the accounting guidance that would require a liability to be recognized. As a consequence, arrangements with similar economic outcomes are accounted for very differently.
- The exploration of the feasibility of reporting all financial instruments at fair value should continue.
- The FASB should continue its work on the accounting guidance that determines whether an issuer would consolidate other entities, including SPEs, in which the issuer has an ownership or other interest.

- In general, certain disclosures in the filings of issuers could be better organized and integrated.

The full text of the staff study can be found at www.sec.gov/news/studies/soxoffbalancerpt.pdf.

Staff Report Concerning Examinations of Select Pension Consultants. Released on May 16, 2005, the report follows an examination sweep into the practices of pension consultants, particularly focused on any conflicts of interest in their operations, and was initiated as part of the SEC's program to identify and investigate risks in the securities industry.

During its examination, SEC staff reviewed documents and information from a cross-section of 24 pension consultants who are registered with the SEC as investment advisers. The examinations reviewed (i) the products and services provided by pension consultants; (ii) the method of payment for such services; and (iii) the disclosures provided to their clients. The report details the findings, including:

- More than half of the pension consultants or their affiliates provided products and services to both pension plan advisory clients and to money managers and mutual funds on an ongoing basis.
- A majority of the pension consultants have affiliated broker-dealers or relationships with unaffiliated broker-dealers which may provide a mechanism for money managers to compensate pension consultants, perhaps as a way to curry favor with the pension consultant.
- Many pension consultants have affiliates that also provide services to pension plan clients.
- Many pension consultants do not adequately disclose material conflicts of interest arising from these practices to their clients.

Although investment advisers owe their clients a fiduciary obligation—including to adequately disclose all material conflicts of interest—some pension consultants appear to have erroneously concluded that they are not fiduciaries to their clients. The report contains recommendations to enhance pension consultants' compliance programs to help ensure that the adviser is fulfilling its fiduciary obligations to its advisory clients.

The report also raises important issues for plan fiduciaries who often rely on the advice and recommendations of pension consultants in operating their plans. In this regard, the SEC will be working with the Department of Labor (DOL) to educate pension fund trustees and other plan fiduciaries about the issues raised by the findings in the report and will continue to work closely with the DOL on issues of mutual interest.

The full text of the staff study can be found at www.sec.gov/news/studies/pensionexamstudy.pdf.

SEC Exemptive Orders

Order Extending Temporary Exemption of Banks, Savings Associations, and Savings Banks from the Definition of "Broker" Under Section 3(a)(4) of the Securities Exchange Act of 1934. The Gramm-Leach-Bliley Act (GLBA) repealed the blanket exception of banks from the definitions of *broker* and *dealer* under the Securities Exchange Act of 1934 and replaced it with functional exceptions incorporated in amended definitions of *broker* and *dealer*. Under the GLBA, banks that engage in securities activities either must conduct those activities through a registered broker-dealer or ensure that their securities activities fit within the terms of a functional exception to the amended definitions of *broker* and *dealer*.

The GLBA provided that the amended definitions of *broker* and *dealer* were to become effective May 12, 2001. On May 11, 2001, the SEC issued interim final rules (Interim Rules) to define certain terms used in, and grant additional exemptions from, the amended definitions of *broker* and *dealer*. Among other things, the Interim Rules extended the exceptions and exemptions granted to banks under the GLBA and Interim Rules to savings associations and savings banks. These rules also included a temporary exemption that gave banks time to come into full compliance with the more narrowly tailored exceptions from broker-dealer registration.

To further accommodate the banking industry's continuing compliance concerns, the SEC delayed the effective date of the bank *broker* and *dealer* rules through a series of orders that, among other things, ultimately extended the temporary exemption from the definition of *broker* to September 30, 2005.

In June 2004, the SEC proposed Regulation B to replace the Interim Rules. Although the comment period for Regulation B expired on September 1, 2004, the SEC has continued to receive comments. As a result, in September 2005, the SEC decided to extend the exemption from the definition of *broker* for banks, savings associations, and savings banks until September 30, 2006, to prevent these financial institutions from unnecessarily incurring costs to comply with the statutory scheme based on the current Interim Rules and to give itself more time to consider fully comments received on Regulation B and take any final action on the proposal as necessary, including consideration of any modification necessary to the proposed compliance date.

SEC No-Action Letter

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

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

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

On February 10, 2005, the SEC issued a no-action letter regarding broker-dealers treating registered investment advisers as if they were subject to AML rules. The prior letter, issued on February 12, 2004, by the staff of the Division of Market Regulation (Division), in consultation with the FinCEN, stated that it would not recommend to the SEC that enforcement action be taken if a broker-dealer treated a registered investment adviser as if it were subject to an AML rule under 31 U.S.C. 5318(h) for the purposes of paragraph (b)(6) of the broker-dealer customer identification rule, 31 CFR 103.122. In the 2004 no-action letter, the Division provided that the letter would be withdrawn without further notice on the earlier of (1) the date upon which an AML program rule for advisers became effective or (2) February 12, 2005. The 2005 no-action letter extends the relief granted in the 2004 no-action letter for 18 more months or until such time as advisers become subject to an AML rule.

As set forth in the 2004 no-action letter, and following further consultation with the FinCEN, the Division staff will not recommend enforcement action to the SEC under Rule 17a-8 if a broker-dealer relies on an investment adviser, before such adviser becoming subject to an AML rule, provided all the other requirements and conditions in paragraph (b)(6) of the CIP rule are met, namely that (1) such reliance is reasonable under the circumstances, (2) the investment adviser is regulated by a federal functional regulator, and (3) the investment adviser enters into a contract requiring it to certify annually to the broker-dealer that it has implemented an AML program and that it will perform (or its agent will perform) specified requirements of the broker-dealer's customer identification program. The relief provided in the 2004 no-action letter and extended by the 2005 no-action letter will be withdrawn without further action on the earlier of (1) the date upon which an AML rule for advisers becomes effective or (2) July 12, 2006.

The complete letter can be viewed at www.sec.gov/divisions/marketreg/mr-noaction/antiml021005.htm.

Commodity Futures Trading Commission Regulations

The following is a summary of some of the rulemaking of the Commodity Futures Trading Commission (CFTC) in late 2004 and during 2005 and other current issues that may be of interest to accountants with respect to financial reporting for futures commission merchants (FCMs). The complete text of these rules, along with other CFTC final rules, including rules adopted and changes made subsequent to the publication of this Audit Risk Alert, can be downloaded from the CFTC's Web site at www.cftc.gov.

Minimum Net Capital for Forex Dealers Based on Off-Exchange Forex Transactions With Retail Customers

The National Futures Association (NFA) proposed and adopted rule amendments that were approved by the CFTC on September 15, 2005, pertaining to the financial requirements for forex dealer members (FDMs) and the sale of off-exchange retail foreign currency futures and options transactions. These amendments impose stricter requirements for the calculation of the minimum adjusted net capital requirement for FDM, and extend certain antifraud and customer protection rules applicable to retail, off-exchange forex transactions to a greater number of NFA members.

NFA members that solicit retail off-exchange forex transactions but are not FDMs because they are not themselves counterparties to such transactions are now specifically required to comply with the antifraud rule provisions formerly applicable only to FDMs.

This applies to all NFA members, unless such members are exempt by virtue of being an enumerated entity subject to alternate regulation (such as financial institutions, insurance companies and regulated subsidiaries and affiliates thereof, financial holding companies or investment bank holding companies), or exempt as being a fully registered securities broker-dealer or material affiliate of a registered securities broker-dealer and member of NASD. The amendment ensures that NFA may take disciplinary action against any nonexempt NFA member (for example, introducing brokers (IBs), commodity trading advisors (CTAs), or commodity pool operators (CPOs)) for using fraudulent promotional material, violating just and equitable principles of trade, or failing to supervise their employees or agents, in the solicitation of retail off-exchange forex transactions regardless of who the counterparty is to the retail customer.

In addition, all such NFA members must now provide retail customers, when they open an account and at least annually thereafter, with information about NFA's Background Affiliation Status Information Center (BASIC) system. The information may be provided electronically by e-mail with an explanatory link, but must be delivered to individual customers, not just accessible to them at a Web site.

The approved amendments also strengthen minimum capital requirements for FDMs. NFA's Financial Requirements Section 11 adopted in 2003 provides that the minimum capital requirement for FDMs is equal to the greater of $250,000, 1 percent of the total net aggregate notional value of all open foreign currency futures and options transactions in customer and noncustomer accounts that are with retail customers and not entered into on an exchange, or any other amount required under NFA financial requirements. The newly adopted amendment to Section 11 excludes the following from the definition of noncustomer: FDMs, their affiliates, their principals, and "any entity that is created or used by an FDM or its principals or affiliates for the purpose of lowering the FDM's capital requirements." The exclusions are intended to prevent an FDM from using offsetting transactions with related parties to artificially reduce the net aggregate notional value of open forex transactions and, thereby, artificially reduce minimum required capital.

The approved amendments to NFA Section 11 also add an additional financial requirement with respect to FDM transactions with unregistered counterparties or affiliates if the positions exceed certain limits. The additional requirements are concentration charges, which apply as follows:

- For unregistered, unaffiliated counterparties, the FDM must apply a haircut equal to 6 percent or 20 percent (depending on the currency) on the uncovered position with that counterparty in excess of 10 percent of the FDM's aggregate long or short positions in that currency.
- For transactions with affiliates, the FDM would apply the same concentration charge to the greater of (1) the sum of the amounts by which the FDM's net open position with any single affiliate exceeds 10 percent of the FDM's total long or short position in a particular currency; or (2) the amount by which the FDM's net open position with all affiliates combined exceeds 10 percent of the FDM's aggregate long or short positions in a particular currency.

Investment of Customer Funds

The CFTC amended Rule 1.25, which sets forth requirements for the investment of customer funds by FCMs and Derivative Clearing Organizations (DCOs). Among numerous changes, the amendments:

- Establish standards for investing in instruments with certain features.
- Expand the list of permitted benchmarks for adjustable rate securities and set other prudential standards for such instruments.
- Make reverse repurchase agreements subject to the concentration limits for direct investments.

- Permit FCMs that are also registered broker-dealers to engage in certain in-house transactions that are similar to repurchase transactions.
- Eliminate the rating requirement for money market mutual funds, but require that they be SEC registered.

The CFTC also adopted several technical amendments including a clarification of the next-day redemption requirement for mutual funds (and the codification of previously published exceptions to that requirement) and a revision of the rating standard for certificates of deposit. Other technical amendments addressed the permissibility of investing in corporate bonds, the inapplicability of segregation rules to securities transferred out of a segregated account pursuant to a repurchase agreement, and the payment and delivery procedures for repurchase and reverse repurchase transactions.

Record of Investments

The CFTC amended Rule 1.27 to establish an auditability standard for investment records. It also adopted a technical amendment in connection with repurchase agreements and in-house transactions by FCM/broker-dealers, requiring that investment records state the current market value of securities that are "invested."

Proposed Rulemaking to Implement Alternative Capital Deductions for Market Risk and Credit Risk

The CFTC issued proposed rulemaking that would affect the capital computations of those FCMs that are also registered with the SEC as securities broker-dealers, and that have obtained written SEC approval to compute alternative deductions for market risk and credit risk in accordance with the standards set forth in 17 CFR 240.15c3-1e. In rule amendments adopted last year, the SEC established a mechanism allowing broker-dealers that satisfied several conditions, including the voluntary consent of their holding companies to consolidated supervision, to obtain written approval to compute alternative capital deductions for their proprietary trading assets. These alternative deductions would incorporate measurements for market risk and credit risk as determined by internal mathematical models used by the broker-dealer. The proposed CFTC rule amendments would permit an FCM, if it also is a broker-dealer and has obtained SEC approval for its alternative deductions of market risk and credit risk, to elect to use these same alternative capital deductions when computing its adjusted net capital under 17 CFR 1.17. In particular, the proposed rulemaking specifies the filing and other requirements that FCMs must comply with in order to elect to use the alternative capital deductions instead of the capital deductions that 17 CFR 1.17(c) would otherwise require. The items that the proposed rules would require FCM/broker-dealers to file with the CFTC include copies of the reports that are filed with the SEC under 17 CFR 240.17a-5(k), that is, the reports that are filed as supplements to the broker-dealer's annual audited reports and that must indicate the results of the external auditor's review of the FCM/broker-dealer's internal risk management control system established and documented in accordance with 17 CFR 240.15c3-4. The FCM/broker-dealer must also file with the CFTC, concurrently with its filing with the SEC, the statement describing the agreed-upon procedures to be used for the external auditor's review of the internal risk management control system.

Amendment to CFTC Rule 155

CFTC Rule 155.3(b)(2) permits FCMs and Rule 155.4(b)(2) permits IBs to take the other side of any order of a customer, subject to market rules, if that customer has given prior consent, as is required by Section 4b(a)(2)(C)(iv) of the Commodity Exchange Act (CEA). On January 27, 2005, the CFTC amended Rule 1.55 to provide that noninstitutional customers may indicate with a single signature, upon the opening of an account, the consent referenced in Rules 155.3(b)(2) and 155.4(b)(2) concerning customer permission for FCMs and IBs to take the opposite side of an order. Before the amendment, CFTC Rule 1.55 permitted a single signature to acknowledge the receipt of various disclosures and the making of certain elections.

The amendment represents further extension of the regulatory effort to streamline the account opening process through elimination of multiple signatures to acknowledge various disclosures. In the same publication, the CFTC also amended Rule 1.55(f) to clarify that the consents required of noninstitutional customers by Rules 155.3(b)(2) and l55.4(b)(2) are not required of institutional customers when they open an account.

CFTC Financial and Segregation Interpretation 10

Section 4d(a)(2) of the CEA and related CFTC regulations (collectively referred to as segregation requirements) require that all funds received by an FCM from a customer to margin, guarantee, or secure futures or commodity options transactions and all accruals thereon be accounted for separately, and not be commingled with the FCM's own funds or used to margin the trades of or to extend credit to any other person. Further, Section 4d(a)(2) has been construed to require that customer funds, when deposited with any bank, trust company, clearing organization, or another FCM, be available to the FCM carrying the customer account upon demand.

In May 2005, the Division of Clearing and Intermediate Oversight (DCIO) issued an amended Interpretation No. 10-1 to prohibit FCMs from depositing, holding, or maintaining margin funds for customer accounts in third-party custodial accounts, except that, under certain specified conditions, those FCMs not eligible to hold the assets of their Registered Investment Company (RIC) customer under the Investment Company Act (that is, due to their affiliation with the RIC or its adviser) may use such accounts.

The amended Interpretation No. 10-1 prohibition against the use of third-party custodial accounts, and the exception thereto, will become effective on February 13, 2006.

Commodity Futures Trading Commission Annual "Dear CPO" Letter

On January 24, 2005, CFTC staff issued its annual letter to CPOs outlining key reporting issues and common reporting deficiencies found in annual financial reports for commodity pools. The letter emphasized the CFTC staff's concerns and, accordingly, may alert the auditor to high-risk issues that could affect assertions contained in the financial statements of commodity pools. CFTC staff suggested that CPOs share the letter with their independent auditors.

Major concerns addressed in the letter are:

- Applicability of generally accepted accounting principles (GAAP) to commodity pools' annual financial statements
- Non-U.S. GAAP reporting
- Reporting of investments in futures contracts in the condensed schedule of investments
- Fund-of-funds disclosures
- Master-feeder structures
- New pools—initial annual reports
- Final annual reports
- Pool annual financial reports and registration of CPOs and CTAs
- Common deficiencies observed in prior years' annual reports
- DCIO and NFA contact information

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

- Distribute the annual report to the pool participants and file one copy with NFA as soon as possible, but no later than the due date. For pools with a December 31, 2005, year end, the due date is Thursday, March 31, 2006 (unless an extension of time has been requested and granted). CPOs operating a fund of funds pool should review the streamlined procedures described in Rule 4.22(f)(2) for claiming an extension of the due date.
- Include a signed oath or affirmation, as required by Rule 4.22(h), with each copy of the annual report filed with the NFA and distributed to all pool participants. Omitting or not signing the oath or affirmation continues to be a

common deficiency in annual financial report filings. Binding the oath as part of the report package or attaching it to the cover page is a best practice followed by a number of CPOs. CPOs electing to use the NFA's existing pilot program for electronic filing for annual reports are exempt from submitting manually signed oaths with the annual reports as the oath and affirmation are made as part of NFA's electronic filing procedure and the CFTC issued exemptive relief to CPOs in order to permit the pilot program. The NFA has petitioned the CFTC to amend its rules to require all CPOs to use electronic filing for annual report submissions beginning with reports for the year ended December 31, 2005. Should such an amendment be proposed, it would be published for public comment before becoming effective.

- If the pool is operating under the exemptions granted in Rule 4.7 or Rule 4.12, include a notation of that fact on the cover page of the report consistent with the requirements of those regulations.
- Report special allocations of partnership equity as required by CFTC Interpretative Letter 94-3, *Special Allocations of Investment Partnership Equity*.
- Net Asset Value:
  - For unitized pools, include information concerning net asset value per outstanding participation unit in the pool as of the end of each of the pool's two preceding years.
  - For nonunitized pools, provide to each participant the total value of that participant's interest or share in the pool as of the end of each of the pool's two preceding fiscal years. For the report filed with the NFA, provide a schedule listing each participant's balances for those years. A code for each participant may be used in lieu of the participant's name. Participants should not receive financial information concerning other participants.
- If the annual report is unaudited (pursuant to the exemption of Rule 4.7):

- The pool operator must make a statement to that effect on the cover page of each report and state that a certified audit will be provided on request of the owners of a majority of the units of participation in the pool who are unaffiliated with the CPO.
- The annual report must nonetheless be presented and computed in accordance with GAAP applied on a consistent basis. This includes the requirements of AICPA Statement of Position (SOP) 95-2, *Financial Reporting by Nonpublic Investment Partnerships*, as amended, and CFTC Interpretative Letter 94-3.
- The annual report must include all other appropriate footnote disclosures.

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

Self-Regulatory Organization Regulations

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

NASD Rulemaking

- *Notice to Members 05-72—Reporting Requirements for "Piggybacking" Arrangements*. On August 26, 2005, the SEC approved amendments to NASD Rule 3150, regarding reporting requirements for clearing firms, and NASD Rule 3230, regarding requirements for clearing agreements. The new rule will become effective on February 20, 2006.

- *Notice to Members 05-45—Agency Securities Lending Disclosure Initiative*. This notice advises broker-dealers engaged in the business of agency securities lending that the Agency Lending Disclosure Taskforce (Industry Taskforce), composed of, among others, representatives of the securities industry, regulators, and the Depository Trust & Clearing Corporation (DTCC), has recommended, through its Agency Lending Disclosure Initiative, certain uniform processes and a proposed calendar of milestones, to help broker-dealers engaged in agency securities lending activities comply with existing rule requirements relating to books and records, net capital requirements, and internal and supervisory controls.

- *Notice to Members 05-38—NASD Reminds Broker-Dealers of Their Responsibilities Regarding Deficits in Introduced Accounts; Immediate Action May Be Required to Ensure Compliance*. NASD is concerned that clearing firms and introducing firms are frequently failing to properly consider deficits in introduced accounts in accordance with an August 1988 interpretation published in *NASD Guide to Rule Interpretations* (May 1996). This notice is intended to remind members of their responsibilities in this regard. In addition, please note that reviews for the proper handling of deficits in introduced accounts will be an integral part of NASD's examination program for both clearing and introducing firms.

- *Notice to Members 05-33—Short Sales in Pilot Securities and Order-Marking Requirements under SEC Regulation SHO*. NASD, in conjunction with the Nasdaq Stock Market, Inc., issued this notice to advise member firms and other interested parties of certain actions and issues surrounding the adoption of Regulation SHO by the SEC. First, on January 3, 2005, and April 15, 2005, the staff of the SEC Division of Market Regulation issued two No-Action Letters granting relief from the order-marking requirements under Regulation SHO in certain circumstances. In this regard, Nasdaq has established a "masking" process, as described in the SEC's April 15, 2005, No-Action Letter. Second, NASD reminded members using their own proprietary or vendor order management systems to accept and execute short sales in Regulation SHO pilot securities that such members are responsible for making appropriate system changes to ensure proper handling of pilot securities. In this regard, NASD encouraged such members to review and test their systems to ensure readiness for the May 2, 2005, Regulation SHO pilot order effective date. Finally, with respect to Order Audit Trail System (OATS) requirements, members also may mark their OATS report consistent with the SEC's order-marking relief. Please see below a brief description of Notice to Members 04-93 which also addresses certain matters related to Regulation SHO.

- *Notice to Members 05-26—NASD Recommends Best Practices for Reviewing New Products*. NASD is concerned about the number of increasingly complex products that are being introduced to the market in response to the demand for higher returns or yield. Some of these products have unique features that may not be well understood by investors or registered persons. Others raise concerns about suitability and potential conflicts of interest. While NASD has and will continue to address specific products as appropriate, NASD also urges firms to take a proactive approach to reviewing and improving their procedures for developing and vetting new products. At a minimum, those procedures should include clear, specific, and practical guidelines for determining what constitutes a new product, ensure that the right questions are asked and answered before a new product is offered for sale, and, when appropriate, provide for post-approval follow-up and review, particularly for products that are complex or are approved only for limited distribution. The purpose of this notice is to remind firms of the kind of questions they should be asking before offering a new product, and to highlight a number of best practices employed by some firms that NASD believes others should consider in reviewing their current procedures.

- *Notice to Members 05-18—NASD Issues Guidance on Section 1031 Tax-Deferred Exchanges of Real Property for Certain*

Tenants-in-Common Interests in Real Property Offerings. This notice addresses Section 1031 tax-deferred exchanges of real property for certain tenants-in-common (TIC) interests in real property offerings. In a TIC exchange, interests in real property are exchanged for instruments that generally are securities for purposes of the federal securities laws and NASD rules. This notice reminds members that when offering TIC interests that are securities to customers, members and their associated persons must comply with all applicable NASD rules, including those addressing suitability, due diligence, splitting commissions with unregistered individuals or firms, supervision, and recordkeeping. In addition, members relying on private offering exemptions from the registration requirements of the Securities Act of 1933 must ensure that their manner of offering TIC interests complies with all applicable requirements, including the prohibition on general solicitation.

- *Notice to Members 04-95—NASD Issues Reminder to Members Regarding the Municipal Securities Rulemaking Board's Implementation of Real-Time Reporting and Dissemination of Transactions in Municipal Securities*. NASD issued this notice to remind firms to prepare for the implementation on January 31, 2005, of the reporting of municipal securities transactions within 15 minutes (real-time reporting), immediate dissemination of such transaction information (real-time dissemination), and automated comparison of inter-dealer transactions in such securities. The changes are set forth in amended Municipal Securities Rulemaking Board (MSRB) Rule G-14 and Rule G-12(f). Firms must review *all* areas of their business activities and determine the effect of the amended reporting and comparison rules and real-time dissemination of information on municipal securities transactions. Among other actions, firms should review and revise policies, practices, and procedures, as needed, of associated persons engaged in trading or selling municipal securities, the firm's investment banking operations, the back office, the business line supervisors of any business or operational area that is affected by the changes, and the firm's legal, compliance, and audit departments.

- *Notice to Members 04-93—Issues Relating to the SEC's Adoption of Regulation SHO*. On June 23, 2004, the Securities and Exchange Commission (SEC) adopted certain provisions of a new short sale regulation, designated Regulation SHO. Regulation SHO consists of new Rules 200 (definitional and order-marking requirements), 202T (short sale price test pilot), and 203 (uniform locate and delivery requirements). Together with the Regulation SHO adopting release, the SEC issued an order establishing a one-year pilot suspending the provisions of SEC Rule 10a-1(a) and any short sale price test of any exchange or national securities association for short sales of certain securities for certain time periods (Pilot). NASD, in conjunction with Nasdaq, issued this notice to advise member firms and other interested parties of several actions and related guidance surrounding the adoption of Regulation SHO. First, on November 30, 2004, NASD filed for immediate effectiveness a proposed rule change to repeal NASD Rule 3110(b)(1), Rule 3210, Rule 3370(b), and Rule 11830, which are duplicative of or overlap with the uniform requirements of Regulation SHO. The repeal of these rules became operative on January 3, 2005, the compliance date of Regulation SHO. Second, NASD and Nasdaq staff have provided information and guidance on several issues relating to Regulation SHO. Questions and answers have been provided relating to the Order Audit Trail System (OATS) rules, the application of Rule 3350 (the short sale rule), the publication and dissemination of the "threshold list" required by Regulation SHO, and excused withdrawal status for market makers that cannot comply with the Regulation SHO preborrow requirements. Finally, NASD highlighted the recent questions and answers published by the SEC relating to Regulation SHO and encouraged members to review this guidance.

- *Notice to Members 04-72—Impermissible Use of Negative Response Letters for the Transfer of Mutual Funds and Variable Annuities (Changes in Broker-Dealer of Record)*. In September 2002, NASD issued Notice to Members 02-57, addressing when a member firm can use "negative response letters" for the bulk transfer of customer accounts, consistent with NASD rules. Since the publication of Notice to Members 02-57, the staff has received a number of inquiries from the membership for guidance on the use of negative response letters to change the broker-dealer of record on a mutual fund or variable insurance product account held directly with the issuer. As indicated in Notice to Members 02-57, changes in the broker-dealer of record under these circumstances fall outside the scope of Notice to Members 02-57. Accordingly, a member must obtain affirmative consent from a customer to direct a change in the broker-dealer of record in either a mutual fund or variable annuity account.

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

Please be aware that securities industry professionals and others can subscribe to NASD's free e-mail service. Among other things, subscribers can obtain weekly notifications of regulatory information and updates, including new speeches, news releases, announcements, and publications. This service would be an excellent source of current information for anyone involved with broker-dealers and who is seeking to learn what regulatory issues may be affecting the industry. You can subscribe to NASD e-mail service at http://apps.nasd.com/contact_us/SubscriptionForm.aspx?lists=prof.

Also, broker-dealers and other interested parties should avail themselves of other resources available on the NASD Web site, including:

- *NASD Manual Online.* Recently redesigned, the manual contains core regulatory content, including rules and by-laws.

- *NASD Rule Filing Status Report.* This provides a comprehensive list of pending rule filings.

- *NASD Frequently Asked Questions.* These clarify rules and better understand compliance requirements.
- *OFAC Search Tool.* This automated tool searches the "Specially Designated Nationals and Blocked Persons" list.

This information is available at www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=606&ssSourceNodeId=612.

NYSE Rulemaking

- *Information Memo 05-62, Approval of Rule 418.25 Which Requires Member Organizations That Have Elected to Be Supervised on a Consolidated Basis to File Supplemental and Alternative Reports with the Exchange.* On August 16, 2005 the SEC approved an amendment to New York Stock Exchange Rule 418 (Audit) related to recent rule amendments under the Securities Exchange Act of 1934, including amendments to Exchange Act Rule 15c3-1, which established an alternative method of computing net capital for broker-dealers that are part of a consolidated supervised entity (CSE). Under NYSE Rule 418, the Exchange may at any time require any member or member organization to provide information mandated by Exchange Act Rule 17a-5, which prescribes the reports that must be filed by brokers and dealers. The amendment adds NYSE Rule 418.25, which enables the Exchange to require member organizations that have elected to be supervised on a consolidated basis to submit to the Exchange FOCUS Report Part II CSE.
- *Information Memo 05-56, "Portfolio Margin" Amendments to Rule 431 (Margin Requirements) and Rule 726 (Delivery of Options Disclosure Document).* On July 14, 2005, the SEC approved amendments to Exchange Rules 431 (Margin Requirements) and 726 (Delivery of Options Disclosure Document). These amendments will now permit the use of a prescribed risk-based margin methodology, for certain specified products, as an alternative to the strategy-based margin requirements currently stipulated in Rule 431(a) through (f). Member organizations will be able to

apply this risk-based methodology to eligible participants meeting certain criteria. This approval is effective immediately, beginning with a pilot period that will expire on July 31, 2007. In addition, amendments to Rule 726 will require disclosure to, and written acknowledgments from, customers in connection with the use of such margin methodology.

- *Information Memo 05-39, Agency Lending Disclosure Initiative*. SEC staff raised concerns regarding the level of transparency and information disclosure in agency securities lending transactions and the impact on credit and regulatory capital monitoring. The long-standing practice in the broker-dealer industry was to record agency securities lending transactions at the agent level, with little or no details disclosed regarding the transactions with, or exposure to, the underlying principal lenders. SEC staff concluded that to comply with existing financial responsibility rules, particularly the net capital rule, broker-dealers engaged in the business of agency securities lending must: (i) maintain books and records of loan activity with each underlying principal lender, (ii) monitor credit exposure to each underlying principal lender, and (iii) calculate regulatory capital exposure to each underlying principal lender. Subsequent discussions on this issue between regulators and the industry led to the formation, in January 2004, of the Agency Lending Disclosure Taskforce (Industry Taskforce). The Industry Taskforce has drafted documents summarizing the industry deliverables in order to ensure agreement with the regulators. Among the documents is a specific timeline for the Agency Lending Disclosure Initiative, which is expected to be complete by the first quarter of 2006. Members and member organizations that engage in the business of agency securities lending should be aware of the Agency Lending Disclosure Initiative. The purpose of the Agency Lending Disclosure Initiative is to establish uniform processes to assist members and member organizations in their compliance with existing rule requirements related to books and records, net capital, and internal controls when engaged in agency securities lending activities. Information on the efforts and all material produced by the Industry Taskforce regarding the Agency Lending Disclosure Initiative can be found on its Web site at www.agencylending.capco.com.

- *Information Memo 05-32, Stock Loan Finders*. Recent examination findings have prompted concern regarding the use of stock loan finders. In many instances these concerns call into question the business justification for interposing a finder in the middle of a transaction. The NYSE has seen only limited instances where a finder is actually providing services that an effective internal stock loan department could not provide. This Information Memo clarifies existing NYSE regulations and sets forth "best practices" regarding the use of such persons.
- *Information Memo 05-25, Unexpected Close of Exchanges and Securities Market Places*. Infrequently, the Exchanges and securities market places are unexpectedly closed for business, such as for a national day of mourning in memory of a former U.S. president. However, the Federal Reserve regional banks, other banks, and DTCC may elect to remain open for clearance and settlement of securities. Such an occurrence was on June 11, 2004, for the funeral of former President Ronald Reagan. In anticipation of future events similar to that one, regarding the applicability of various regulations, the NYSE outlined in this Information Memo guidelines to be followed by its members and member organizations in the event that such an unexpected close should occur again.
- *Information Memo 05-11, Customer Account Sweeps to Banks*. In view of market conditions and the increasingly competitive industry environment, member organizations continuously seek to develop and offer customers new investment services and products, such as the "cash sweep" account programs. In some cases, however, cash sweep account programs at member organizations may have been instituted or changed without fully appropriate levels of

disclosure and customer consent. Such programs transfer customer funds over time out of the member organization to an interest-bearing account for the customer at a bank often affiliated with the member organization. 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 account protected by the Federal Deposit Insurance Corporation may be deemed to be included as a credit in the reserve formula. In addition, any receivable on the broker-dealer's books resulting from a sweep may be deemed to be a nonallowable asset. This Information Memo addresses issues involving the adoption of new cash sweep programs and provides procedures designed to safeguard investor interests for programs currently in place. It has been prepared to set out best practices under current Exchange rules. The NYSE will further explore the need for rule-making in this area in the near future.

- *Information Memo 05-06, Introducing Broker-Dealers Acting as Principal in Reverse Repurchase and Repurchase Transactions*. It has come to the attention of the NYSE that there are introducing broker-dealers acting as principal parties to reverse repurchase and repurchase transactions. An introducing broker-dealer, as well as its carrying/clearing broker-dealer who acts as agent in these reverse repurchase and repurchase transactions, must comply with the certain minimum guidelines and requirements, as prescribed by the SEC, if the broker-dealers want to continue to conduct such transactions. This Information Memo describes those guidelines.

- *Information Memo 04-58, Supervision of Proxy Activities and Over-Voting*. Rule 452 (Giving Proxies by Member Organization) regulates the processes and procedures by which the shares of beneficial owners are to be voted by member firms. The integrity of the voting process depends upon effective supervision at member organizations. Several recent special examinations of member organizations' proxy departments have discovered significant areas of concern involving an apparent systemic over-voting of proxies and a general lack of effective supervision. Together with a survey conducted on proxy voting and related procedures, these examinations highlight a need for member organizations to review their supervision of proxy activities and related recordkeeping procedures and to focus on the prevention of over-voting. Problems noted in the special examinations and proxy survey chiefly arose for three reasons: (1) failing to properly account for firm and customer short positions when calculating the firm's long position; (2) incorrectly including shares that had been lent in the calculation of the firm's position; and (3) having failed to correctly calculate the long position, then failing to use 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.

- *Information Memo 04-54, Adoption of New Provisions Affecting the Regulation of Short Sales*. On July 28, 2004, the SEC adopted new provisions for the regulation of short sales. Regulation SHO and other concurrent SEC actions provide for significant changes to the SEC short sale rules and affect NYSE Rules 440B (Short Sales) and 440C (Deliveries Against Short Sales). As part of these actions, the SEC rescinded its Rules 3b-3 (Definition of Short Sale) and 10a-2 (Requirements for Covering Purchases), under the Securities Exchange Act of 1934, replacing them with new Rules 200 (Definition of Short Sale and Marking Requirements) and 203 (Borrowing and Delivery Requirements for Short Sales), of Regulation SHO. In addition, the SEC amended Rule 10a-1 (Short Sales) to conform to Regulation SHO, and Rule 105 of Regulation M to remove the rule's shelf offering exception. This Information

Memo summarizes these new rule provisions and their impact on NYSE Rules.

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

NFA Rulemaking

NFA Pilot Program for Electronic Filing of Pool Financial Statements. The National Futures Association has developed EasyFile, a Web-based system for CPOs to file their pool financial statements (PFS) electronically. The system was available in January 2005 for the December 31, 2004, PFS filings on a voluntary basis. EasyFile for CPOs involves a three-step process:

1. Upload a PDF of the identical PFS provided to the pool's limited partners, including the CPO's oath or affirmation, footnotes, and the Independent Auditor's Opinion, if applicable.

2. Enter key financial balances into a standardized form or schedule.

3. Validate the submission to process some basic edit checks by the system and prompt the submitter to read and agree to an electronic oath or affirmation.

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

OCC Rulemaking

Calculating Net Capital Under OCC Rule 307. On June 13, 2005, the SEC approved the proposed rule change filed by the Options Clearing Corporation (OCC) regarding calculation of net capital under OCC Rule 307. The proposed rule change amends OCC Rule 307 by adopting Interpretation and Policy .01 (IP .01) that requires clearing members that could otherwise take advantage of SEC Rule 15c3-1(a)(6) under the Securities Exchange Act to include the risk-based haircuts associated with proprietary securities positions in determining their compliance with OCC's minimum net capital requirements.

OCC Rule 307 requires a clearing member to compute its "net capital," "aggregate indebtedness," and "debt-equity total" in accordance with SEC Rule 15c3-1 under the Securities Exchange Act for purposes of OCC Rules. New IP .01 under OCC Rule 307 requires clearing members that could otherwise take advantage of SEC Rule 15c3-1(a)(6) to deduct the risk-based haircuts associated with proprietary securities positions in determining their compliance with OCC's minimum net capital requirements. Although the exemption in Rule 15c3-1(a)(6) from the securities haircuts in Rule 15c3-1(c)(2)(vi) and Appendix A under Rule 15c3-1 ensures from a systemic standpoint that capital exists to support open positions, it does not ensure that capital is maintained in the entity to which OCC has credit exposure. As a result, OCC is exposed to the volatility of the positions relative to the clearing member's net income without any reserve against net capital. OCC believes that the exemption in Rule 15c3-1(a)(6) gives those clearing members added leverage enabling them to expand positions to several times their net capital. IP .01 became effective on July 27, 2005. For more information please refer to SEC Release No. 34-51286 and OCC Rules that can be found at http://www.theocc.com/publications/bylaws/bylaws.jsp.

Audit and Accounting Issues and Developments

Guidance Related to Natural Disasters

Auditing Technical Practice Aids

In September, following the destruction caused by Hurricane Katrina, the AICPA's Audit and Attest Standards Team issued several Technical Practice Aids (TPAs) to address some of the questions that arose in the aftermath of this disaster. TPA section 9070.05, entitled "Consideration of Impact of Losses From Natural Disasters Occurring After Completion of Audit Field Work and Signing of the Auditor's Report But Before Issuance of the Auditor's Report and Related Financial Statements," addresses the auditor's responsibilities with respect to consideration of a material subsequent event that occurs after completion of field work and after the signing of the auditor's report but before issuance of the auditor's report and the audited financial statements.

According to the TPA, a loss from a natural disaster occurring after year end would be considered a type II subsequent event. Paragraph .05 of AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), defines such a subsequent event as an event that provides evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date. These events should not result in an adjustment to the financial statements. Some of these events, however, may be of such a nature that disclosure of them is required to keep the financial statements from being misleading. For example, if your client owns a major distribution center in an area that is declared a disaster area by a local, state, or federal government due to Hurricane Katrina (or another natural disaster), you, along with management, should assess the damage done to that asset and the impact on the entity's current and future operations and determine whether disclosure of the impact of the disaster is required to keep the financial statements from being misleading. To access this TPA, visit www.aicpa.org/download/members/div/auditstd/TPA-Subsequent%20Events.pdf.

TPA section 8345.01, "Audit Considerations When Client Evidence and Corroborating Evidence in Support of the Financial Statements Has Been Destroyed by Fire, Flood, or Natural Disaster," and TPA section 8345.02, "Considerations When Audit Documentation Has Been Destroyed by Fire, Flood, or Natural Disaster," provide guidance to auditors facing the question about what to do when client evidential matter and/or audit documentation are destroyed due to fire, flood, or natural disaster (such as Hurricane Katrina). These TPAs can be accessed at www.aicpa.org/download/members/div/auditstd/TPA_Destruction_of_Documentation.pdf.

Accounting Technical Practice Aid

Also in September, the AICPA issued TPA section 5400.05, "Accounting and Disclosures Guidance for Losses from Natural

Disasters," to identify accounting literature that gives guidance on the following accounting issues that may arise in accounting for losses from natural disasters:

- Classifying, in the statement of operations, losses from a natural disaster of a type that is reasonably expected to recur
- Recognizing an asset impairment loss related to a natural disaster
- Recognizing a liability for nonimpairment losses and costs related to a natural disaster
- Accounting for insurance recoveries to cover losses sustained in a natural disaster, and additional considerations related to business interruption insurance recoveries
- Fulfilling required disclosures regarding the impact of a natural disaster

This TPA can be accessed at www.aicpa.org/download/acctstd/Natural_disaster_TPA_5400.05.pdf.

Tax Relief

The deadline to file tax returns and pay any taxes due has been extended to February 28, 2006, for taxpayers affected by Hurricanes Katrina and Rita, including businesses in the disaster area. In addition to the postponed deadlines, the IRS announced interest and fees resulting from late filing, late payments, or failure to deposit penalties will be abated for any tax return, for which the payment of deposit has an original or extended due date on or after September 23, 2005. For more information about tax relief measures available to taxpayers affected by the hurricanes, visit the IRS Web site at www.irs.gov/.

Regulatory Guidance

SEC. On September 15, 2005, the SEC issued an order providing emergency regulatory relief to investors, companies, and securities firms affected by Hurricane Katrina. Relief measures include extensions of filing deadlines and suspension of requirements to deliver documents to hurricane-affected areas. The relief also provides an exemption from complying with the auditor independence requirements as they relate to auditors performing bookkeeping services for audit clients, provided certain conditions are met. For more information, please go to www.sec.gov/rules/exorders/34-52444.pdf to access the complete text of the relief. You can also visit the SEC's Web site devoted to "Hurricane Katrina Regulatory Relief and Assistance" at www.sec.gov/katrina.htm for additional information.

NASD. On September 6, 2005, NASD Issued Notice to Members 05-57, *Guidance to Members Affected by Hurricane Katrina*, to address concerns of members with offices in the affected areas in connection with a number of regulatory and compliance issues. In this Notice to Members, NASD provides guidance on a number of issues, including guidance on emergency office relocations, continuing education requirements for registered personnel, registered personnel engaged in active military duty, books and records, the handling of customers' funds and securities, and customer communications.

NYSE. NYSE Information Memo 05-63, *Guidance Pertaining to Hurricane Katrina*, addresses issues similar to the ones addressed in NASD Notice to Members 05-57. The NYSE also issued Information Memo 05-71, *Guidance Pertaining to Hurricane Rita*, advising the membership that the guidance offered in Information Memo 05-63 is also applicable to any areas similarly affected by Hurricane Rita. However, Information Memo 05-71 offers some additional guidance that can be applied to areas affected by both Hurricanes Rita and Katrina. In October 2005, NYSE issued Information Memo 05-80, *Business Continuity and Contingency Plans*, as a follow up to NYSE Information Memo No. 04-24, which addresses the requirements of NYSE Rule 446, *Business Continuity and Contingency Plans*. The unfortunate aftermaths of Hurricanes Katrina and Rita reinforced the need for members and member organizations to have effective Business Continuity and Contingency Plans (BCPs) in place. Information Memo 05-80 provides general guidance and responds to specific questions that have arisen in connection with BCPs. It is intended to assist members and member organizations in developing comprehensive and effective BCPs.

Disaster Response Checklist for CFOs and Controllers

The AICPA has developed a checklist to help financial executives navigate through the complicated task of disaster recovery. When a company faces a disaster, whether it is a local or regional situation, it must address a variety of issues in a timely manner. This checklist helps walk the finance executive through disaster response in a series of phases, outlining issues that need to be addressed to understand damage and minimize ongoing risks, including ensuring employee safety, maintaining operations, and evaluating the company's financial situation. To access the checklist, visit www.aicpa.org/news/2005/disaster_response.htm.

Online Disaster Recovery Resource Center

The AICPA has established a central online Disaster Recovery Resource Center. Visit this site frequently for up-to-date information, useful links to other Web sites, and a wide range of practical tools on this topic. It includes resources for members to use to assist their employers and clients, as well as practice management guidance for firms directly affected by Hurricane Katrina. The site will be updated regularly; check back often.

Report on Internal Control

SEC Rule 17a-5, *Reports to Be Made by Certain Brokers and Dealers*, 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. The SEC requires independent auditors to issue a report on broker-dealers' internal control. To meet this requirement, a report should (*a*) express an opinion on the adequacy of the practices and procedures listed in SEC Rule 17a-5(g)(1) in relation to the definition of a material inadequacy as stated in SEC 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. CFTC Regulation 1.16, *Qualifications and Reports of Accountants*, requires independent auditors of entities it regulates to issue a similar report on internal control.

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.*

CFTC Regulation 1.16d(2) provides a similar definition.

In addition to material inadequacies, reports on internal control submitted to the SEC and CFTC should also address the existence of material weaknesses as defined in AU section 325, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1), as amended. AU section 325 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. Paragraph 3.81 of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* (the Guide) indicates that 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. Please refer to the SEC and CFTC rules as well as paragraphs 3.77 through 3.87 of the Guide for additional guidance on broker-dealer internal control reporting.

On June 17, 2004, the SEC approved PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. This standard establishes requirements that apply when an auditor is engaged to audit both an issuer's financial statements and management's assessment of the effectiveness of internal control over financial reporting. Following the issuance of this standard the number of material weaknesses and material inadequacies reported to the regulators has increased. This can partially be attributed to increased awareness about internal control in light of the issuance of PCAOB Auditing Standard No. 2. Also, 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 PCAOB standards. As auditors perform more internal control work for such broker-dealer clients, they become aware of additional issues and areas where problems may arise, which could also explain the increase in the number of reported material weaknesses and material inadequacies.

In September 2005, the Auditing Standards Board (ASB) reexposed a proposed SAS entitled *Communication of Internal Control Related Matters Noted in an Audit*, which would supersede AU section 325. The original exposure draft, which was issued in March 2003, was revised for certain matters noted in comment letters as well as for conforming changes to reflect certain definitions and related guidance in PCAOB Auditing Standard No. 2. Under the proposed SAS the definition of material weakness and related evaluation guidance is consistent with PCAOB Auditing Standard No. 2.

Auditor-initiated adjusting journal entries are common for broker-dealer clients and in the past had not often been reported to regulators as material weaknesses or material inadequacies unless those entries resulted from a systemic problem, affected net capital, or had an impact on customers. Under both PCAOB Auditing Standard No. 2 and the proposed SAS, identification by the auditor of a material misstatement in financial statements for the period under audit that was not initially identified by the entity's internal control is at least a significant deficiency and a strong indicator that a material weakness in internal control over financial reporting exists. Both standards indicate that this is a strong indicator of a material weakness even if management subsequently corrects the misstatement. In light of that guidance, adjustments that previously were not considered material weaknesses would potentially be treated as such if they are material to the broker-dealer's audited financial statements. Also, every time a reconciliation for the computation of net capital or for determination of the reserve requirements is provided along with the audited financial statements, the auditor should consider if there is a material weakness or material inadequacy. The comment period for the proposed SAS ended on October 31, 2005. Readers can view the Exposure Draft at www.aicpa.org/members/div/auditstd/Internal_Control_Related_Matters.htm. Auditors should be alert to the issuance of the final Statement as it is likely to have a significant impact on broker-dealer internal control reporting.

Discretionary Liabilities

Broker-dealers' pay structure is not significantly different from other industries, except that at broker-dealers bonuses usually represent a greater percentage of an individual's total compensation. When compensation is based upon performance, such as for proprietary traders, the auditor should be concerned that the broker-dealer is properly accruing such compensation.

Bonus determination is one of the key estimates for broker-dealers and involves a high degree of management judgment and subjectivity, as bonuses, such as trader compensation or annual bonuses, are often based on a performance period different than the financial statement accounting period. Auditors should follow AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1; for audits conducted under PCAOB standards: AICPA, *PCAOB Standards and Related Rules*), which provides guidance on obtaining and evaluating sufficient, competent evidential matter in support of accounting estimates included in the financial statements.

In certain instances, compensation based upon performance may be discretionary. Broker-dealers should follow the guidance in paragraphs 35 through 40 of FASB Statement of Concepts No. 6, *Elements of Financial Statements*, in determining whether they need to recognize a liability for discretionary compensation. Paragraph 40 of FASB Statement of Concepts No. 6 states that "although most liabilities stem from legally enforceable obligations, some liabilities rest on equitable or constructive obligations, including some that arise in exchange transactions. … A constructive obligation is created, inferred, or construed from the facts in a particular situation rather than contracted by agreement with another entity or imposed by government. For example, an entity may create a constructive obligation to employees for vacation pay or year-end bonuses by paying them every year even though it is not contractually bound to do so and has not announced a policy to do so." Therefore, a broker-dealer's prior history of paying bonuses is an indicator that a discretionary compensation liability needs to be accrued.

A broker-dealer's financial statements prepared in accordance with GAAP should reflect an accrual for discretionary compensation, even though certain discretionary liabilities, such as a noncontractual bonus accrual, may be added back to the broker-dealer's net worth for determining net capital.

Until recently NASD member firms were required to provide a basis for treating a recorded liability as a discretionary obligation in the form of an opinion of counsel letter. This requirement was recently eliminated, as NASD replaced oral guidance given to it from the SEC Division of Market Regulation with an interpretation provided through No-Action Letter guidance and the firms no longer are required to submit to NASD such a letter. This interpretive guidance can be found on NASD's Web site at www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_015353.

Yet, as an auditor of a broker-dealer, you need to be satisfied concerning the propriety of the discretionary compensation accrual and the appropriateness of its consideration for net capital calculation purposes.

Value of Exchange Memberships

During the past year, the value of U.S. exchange memberships has continued to fluctuate, with NYSE seats being affected the most. In December 2005, NYSE's membership prices broke a record, with a seat selling for $4 million, while only in January the prices reached a multiyear low of $975,000. Behind the unprecedented increase in NYSE seat prices are the Exchange's plans to acquire an electronic stock-exchange operator, Archipelago Holdings Inc., and to become a public company.

Although changes in the value of exchange memberships do not affect regulatory net capital, because exchange memberships are excluded from the net capital calculation, such changes continue to raise concerns about the value of such assets reported in financial statements prepared in accordance with GAAP. Following the issuance of FASB Statement of Financial Accounting No. 142, *Goodwill and Other Intangible Assets*, the AICPA and FASB staff had been discussing the appropriateness of accounting guidance for exchange memberships provided in paragraph 7.34 of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* (the Guide).

The 2005 edition of the Guide was revised to distinguish between the two kinds of exchange memberships: (1) those representing ownership rights and (2) those representing *only* usage rights. Exchange memberships that 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, should be accounted for at cost or at a lesser amount if there is an other-than-temporary impairment in value.

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

As an auditor of a broker-dealer, you need to be satisfied concerning the propriety of the carrying value of a membership and whether the carrying value has been impaired, as required by paragraph 5.156 of the Guide.

Mandatorily Redeemable Instruments

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

This Statement may have a significant impact on the financial statements of certain broker-dealers. For example, under FASB Statement No. 150, broker-dealers that have issued shares that must be sold back to the company upon the holder's death or termination of employment must record those shares as liabilities, rather than equity, as they previously were treated under GAAP, because the shares are mandatorily redeemable upon an event certain to occur. Further, if a holding company has mandatorily redeemable shares and the only way the holding company can meet those redemptions is to withdraw funds from the broker-dealer subsidiary, those effects must be pushed down to the broker-dealer. As a result, some broker-dealers may report significantly lower or no equity in their GAAP financial statements when compared to prior reporting. From a regulatory standpoint, application of FASB Statement No. 150 can (1) cause a broker-dealer to fall below its minimum net capital requirements under Rule 15c3-l(a) or (2) cause its subordinated debt to debt-equity total to increase above the 70 percent limit set forth in Rule 15c3-l(d). Broker-dealers may have amended, 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.

To address this issue, a number of broker-dealers have eliminated from their agreements the requirement that the company buy back equity upon an owner's death or termination of employment, and instead, put in place *cross buy-sell agreements*. A cross buy-sell agreement is an agreement among owners that says that under stated conditions, that is, the death or termination of employment, the person withdrawing from the company or his or her heirs are legally obligated to sell their interest to the remaining owners (not the company), and the remaining owners are legally obligated to buy at a price fixed in the agreement.

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

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

Lease Accounting

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 during which 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 SEC letter can be accessed at www.sec.gov/info/accountants/staffletters/cpcaf020705.htm.

AICPA staff has issued a set of questions and answers related to accounting for operating leases. The questions and answers, which are applicable to public companies, private companies, and not-for-profit organizations, focus on issues that resulted in restatements earlier this year. They can be found at www.aicpa.org/members/div/acctstd/general/recent_tpas.asp.

In November 2005, the AICPA issued a set of TPAs in the form of questions and answers related to accounting for operating leases. The TPAs, which are applicable to public companies, private companies, and not-for-profit organizations, focus on issues that resulted in restatements earlier this year. Below is the list of lease TPAs along with a brief description of the issues they address:

- TPA section 5600.07, on determining the lease term of a lease.
- TPA section 5600.08 and TPA section 5600.09, on whether a lease term can predate an initial fixed noncancelable term stated in a lease agreement.
- TPA section 5600.10 and TPA section 5600.11, on how a lessee should accrue rent expense and how a lessor should recognize rent revenue in an operating lease.
- TPA section 5600.12, on how a rent holiday included in an operating lease should factor into the lessee's recognition of rent expense and the lessor's recognition of rent revenue.
- TPA section 5600.13, on how a lessee should accrue rent expense and how a lessor should recognize rent revenue using the straight line method when the lease agreement contains scheduled rent increases over the lease term.
- TPA section 5600.14 and TPA section 5600.15, on determining the period for which a lessee should amortize/depreciate leasehold improvements in an operating lease.

- TPA section 5600.16, on determining the landlord incentive allowance in an operating lease.
- TPA section 5600.17, on how a lessee should categorize expenditures for leasehold improvements and a related cash incentive allowance received from a landlord in the statement of cash flows.

These TPAs are available on the AICPA website and can be accessed at www.aicpa.org/members/div/acctstd/general/recent_tpas.asp.

Litigation, Claims, and Assessments

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 or even the suspension or revocation of the broker-dealer's registration. Over the past year regulators penalized a number of securities firms over such matters as directed brokerage violations, improper sale of mutual fund shares, IPO violations, and municipal trade reporting violations, just to name a few.

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

In addition, auditors need to be aware of their responsibilities under AU section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1). AU section 337 provides guidance on the procedures an independent auditor should consider for identifying litigation, claims, and assessments and for the financial accounting and reporting of such matters when performing an audit in accordance with GAAS. It provides, in part, that auditors should obtain evidential matter relevant to the following factors:

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

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

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

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

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

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

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

AICPA 2005 Audit and Accounting Guide *Brokers and Dealers in Securities*

AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* (the Guide), with conforming changes as of May 1, 2005, has been updated to reflect the issuance of recently issued authoritative pronouncements. The Guide is available through the

AICPA's reSOURCE Online and reSOURCE CD-ROM products, as well as through a loose-leaf subscription service. Paperback editions of Audit and Accounting Guides can be purchased as well.

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

Recent Auditing and Attestation Pronouncements, and Related Guidance

Presented below is a list of auditing and attestation pronouncements, and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards, quality control standards, and other guidance that may have been issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm and the PCAOB Web site at www.pcaobus.org (public company audits only). You may also look for announcements of newly issued standards in the *CPA Letter, Journal of Accountancy*, and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA's Auditing Standards team and available at www.aicpa.org/members/div/auditstd/opinion/index.htm.

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

The standards and interpretations promulgated by the AICPA Auditing Standards Board (ASB) are available free of charge by visiting the AICPA's Audit & Attest Standards Team's page at www.aicpa.org/members/div/auditstd/Auth_Lit_for_NonIssuers.htm. Members and nonmembers alike can download the auditing, attestation, and quality control standards by either choosing a section of the codification or an individual statement number.

You can also obtain copies of AICPA standards and other guidance by contacting the Member Satisfaction Center at (888) 777-7077 or online at www.cpa2biz.com.

AICPA AU Section 120 AICPA AT Section 20 (December 2005) (Applicable to audits conducted in accordance with GAAS)	*Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1) *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1) These pronouncements define the terminology to describe the degrees of responsibility that the requirements impose on the auditor or the practitioner.
AICPA AU Section 339 (December 2005) (Applicable to audits conducted in accordance with GAAS)	*Audit Documentation* This SAS supersedes AU section 339 of the same name (AICPA, *Professional Standards*, vol. 1) and establishes standards and provides guidance to an auditor of a nonissuer on audit documentation for audits of financial statements or other financial information being reported on. The standard includes amendments to paragraphs .01 and .05 of AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1). The amendment requires that the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient competent audit evidence to support the opinion on the financial statements. The standard also contains an amendment to paragraph .05 of AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). The amendment adds a requirement for the auditor to document his or her justification for a departure from the SASs in the working papers.
AICPA Audit Interpretation No. 1 of AU Section 328, *Auditing Fair Value Measurements and Disclosures* AICPA Audit Interpretation No. 1 of AU Section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments*	"Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value" "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist" These Interpretations are discussed below in the "Auditing Fair Values" section.

in Securities (July 2005) (Applicable to audits conducted in accordance with GAAS)	
AICPA Audit Interpretation No. 1 of AU Section 625, *Reports on the Application of Accounting Principles* (January 2005) (Applicable to audits conducted in accordance with GAAS)	"Requirement to Consult With the Continuing Accountant" This Interpretation provides guidance on when an accountant in public practice, acting in the capacity of an advisory accountant, may be able to overcome the presumptive requirement of paragraph .09 of AU section 625 to consult with the continuing accountant.
AICPA Audit Interpretation No. 12 to AU Section 623, *Special Reports* (amended January 2005) (Applicable to audits conducted in accordance with GAAS)	"Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis" This Interpretation clarifies that financial statements prepared on a statutory basis are financial statements prepared on a comprehensive basis of accounting other than GAAP, and provides general guidance on disclosures necessary for financial statements prepared on an other comprehensive basis of accounting.
AICPA Audit Interpretation No. 14 to AU Section 623, *Special Reports* (amended January 2005) (Applicable to audits conducted in accordance with GAAS)	"Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)" This Interpretation provides guidance on necessary disclosures for financial statements prepared on an other comprehensive basis of accounting.
AICPA Audit Interpretation No. 15 to AU Section 623, *Special Reports* (January 2005) (Applicable to audits conducted in accordance with GAAS)	"Auditor Reports on Regulatory Accounting or Presentation When the Regulated Entity Distributes the Financial Statements to Parties Other Than the Regulatory Agency Either Voluntarily or Upon Specific Request" This Interpretation provides illustrative language for an auditor's report prepared on a regulatory basis of accounting prescribed by a regulatory agency, where the financial statements are not prepared solely for filing with that agency.
AICPA Attest Interpretation No. 6 of AT Section 101,	"Reporting on Attestation Engagements Performed in Accordance With Government Auditing Standards"

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Attest Engagements (December 2004) (Applicable to audits conducted in accordance with GAAS)	This Interpretation provides illustrative language for an attestation report for engagements performed pursuant to generally accepted government auditing standards.
AICPA Technical Practice Aid Section 9070.05 (August 2005) (nonauthoritative)	"Consideration of Impact of Losses From Natural Disasters Occurring After Completion of Audit Field Work and Signing of the Auditor's Report But Before Issuance of the Auditor's Report and Related Financial Statements"
AICPA Technical Practice Aid Section 8345.01 (September 2005) (nonauthoritative)	"Audit Considerations When Client Evidence and Corroborating Evidence in Support of the Financial Statements Has Been Destroyed by Fire, Flood, or Natural Disaster"
AICPA Technical Practice Aid Section 8345.02 (September 2005) (nonauthoritative)	"Considerations When Audit Documentation Has Been Destroyed by Fire, Flood, or Natural Disaster"
AICPA Practice Alert 2005-01 (September 2005) (nonauthoritative)	*Auditing Procedures With Respect to Variable Interest Entities* The purpose of this Practice Alert is to provide guidance to auditors in planning and performing auditing procedures with respect to variable interest entities.
PCAOB Auditing Standard No. 4 (Issued as a final standard by the PCAOB, awaiting SEC approval) (Will be applicable to audits conducted in accordance with PCAOB standards when approved by the SEC)	*Reporting on Whether a Previously Reported Material Weakness Continues to Exist* This standard applies if auditors report on the elimination of a material weakness in a company's internal control over financial reporting. The standard establishes a voluntary engagement that would be performed at the election of the company.
PCAOB Conforming Amendment (Issued as a final standard by the PCAOB, awaiting SEC approval) (Will be applicable to audits conducted in accordance with PCAOB standards when approved by the SEC)	*Conforming Amendment to PCAOB Related Auditing and Professional Practice Standards Resulting from the Adoption of the Auditing Standard No. 4*

PCAOB Rules (Issued as a final standard by the PCAOB, awaiting SEC approval) (Will be applicable to audits conducted in accordance with PCAOB standards when approved by the SEC)	*Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees* See the AICPA *Independence and Ethics Alert—2005/06* for further information.
PCAOB Staff Questions and Answers (Various dates) (Applicable to audits conducted in accordance with PCAOB standards)	1. *Auditing Internal Control over Financial Reporting*—The PCAOB has issued two sets of questions and answers in 2005 relating to the issuance of PCAOB No. 2—question 37, and questions 38–55 2. *Attest Engagements Regarding XBRL Financial Information Furnished Under the XBRL Voluntary Financial Reporting Program on the EDGAR System*
AICPA Audit and Accounting Practice Aid (nonauthoritative)	*The Auditor's Guide to Understanding PCAOB Auditing Standard No. 2* This publication walks an auditor through all the key requirements of PCAOB Auditing Standard No. 2 and provides insight and analysis on what those requirements mean.
AICPA Audit and Accounting Practice Aid (nonauthoritative)	*SAS No. 70 Reports and Employee Benefit Plans* This publication provides guidance on the use of SAS No. 70 reports in audits performed in accordance with GAAS. In addition, this publication includes checklists and forms to help implement the guidance.
AICPA Audit and Accounting Practice Aid (nonauthoritative)	*Illustrative Disclosures on Derivative Loan Commitments* This Practice Aid provides illustrations of disclosures of derivative loan commitments in accordance with the reporting and disclosure guidance cited in SEC Staff Accounting Bulletin No. 105, *Application of Accounting Principles to Loan Commitments.*
Accounting Trends & Techniques (nonauthoritative)	*Employee Benefit Plans* This publication provides extensive illustrative financial statements and note disclosures for employee benefit plans.

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Guidance on Management Override of Internal Controls (nonauthoritative)	*Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention—The Audit Committee and Oversight of Financial Reporting* This guidance is available through the AICPA Audit Committee Effectiveness Center at www.aicpa.org/audcommctr (go to "Spotlight Area").

Auditing Fair Values

In July of 2006 the ASB issued the following two interpretations of SASs pertaining to auditing fair values:

- "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value," which interprets AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1).
- "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist," which interprets AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1).

The interpretations clarify 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.

The Interpretations also reiterate the responsibility of management to institute accounting and financial reporting processes for the determination of fair value measurements. According to the Interpretations, if the auditor is unable to audit the existence or measurement of interests in investments in securities at the financial statement date, the auditor should consider whether that scope limitation requires the auditor to qualify his or her opinion or disclaim an opinion. The interpretations are posted on the AICPA's Web site at www.aicpa.org/download/auditstd/announce/Audit_Interpretations_Auditing_Fair_Value.pdf.

Recent AICPA Independence and Ethics Pronouncements

The AICPA *Independence and Ethics Alert—2005/06* (product no. 022476) contains a complete update on new independence and ethics pronouncements. This Alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain that Alert to be aware of independence and ethics matters that will affect their practice.

Recent Accounting Pronouncements and Related Guidance

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

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

FASB Statement No. 152 (December 2004)	*Accounting for Real Estate Time-Sharing Transactions—an amendment of FASB Statements No. 66 and 67* This Statement amends FASB Statement No. 66, *Accounting for Sales of Real Estate*, to reference the financial accounting and reporting guidance for real estate time-sharing transactions that is provided in AICPA SOP 04-2, *Accounting for Real Estate Time-Sharing Transactions*. This Statement also amends FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to state that the guidance for (1) incidental operations and (2) costs incurred to sell real estate projects does not apply to real estate time-sharing transactions. The accounting for those operations and costs is subject to the guidance in SOP 04-2.
FASB Statement No. 153 (December 2004)	*Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29* This Statement amends APB Opinion 29, *Accounting for Nonmonetary Transactions*, to eliminate the exception for nonmonetary exchanges of similar productive assets, and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange.
FASB Statement No. 123(R) (December 2004)	*Share-Based Payment* This Statement is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*; it supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance. This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. It establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments.

FASB Statement No. 154 (May 2005)	*Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3* This Statement replaces APB Opinion No. 20, *Accounting Changes*, and FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*, and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions.
FASB Interpretation No. 47 (March 2005)	*Accounting for Conditional Asset Retirement Obligations—an interpretation of FASB Statement No. 143* This Interpretation clarifies that the term *conditional asset retirement obligations* describes a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may not be under the entity's control.
FASB EITF Issues (Various dates)	Go to www.fasb.org/eitf/ for a complete list of EITF Issues.
FASB Staff Positions (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FASB Staff Positions (FSPs). Some of the recently issued FSPs address issues relating to FASB Statements No. 143 and No. 150, among others; and FASB Interpretation No. 46(R).
AICPA Statement of Position 05-1	*Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*
AICPA Technical Practice Aid Section 1200.06-1200.15 (February 2005) (Nonauthoritative)	"Accounting by Noninsurance Enterprises for Property and Casualty Insurance Arrangements That Limit Insurance Risk"
AICPA Technical Practice Aid Section 5400.05	"Accounting and Disclosure Guidance for Losses from Natural Disasters—Nongovernmental Entities"

(continued)

(September 2005) (Nonauthoritative)	
AICPA Technical Practice Aid Section 6930.09 (August 2005) (Nonauthoritative)	"Accounting and Disclosure Requirements for Single-Employer Employee Benefit Plans Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003"
AICPA Technical Practice Aid Section 6930.10 (August 2005) (Nonauthoritative)	"Accounting and Disclosure Requirements for Multiemployer Employee Benefit Plans Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003"

Below is a discussion of some of the recently issued pronouncements that have particular significance to the securities industry. These summaries are for informational purposes only and should not be relied on as a substitute for a complete reading of the applicable pronouncement.

FSP No. EITF 85-24-1

In March 2005, the FASB issued FSP No. 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,' When Cash for the Right to Future Distribution Fees for Shares Previously Sold Is Received from Third Parties," to give guidance on whether cash received from a third party for a distributor's right to future cash flows relating to distribution fees for shares previously sold can be recognized as revenue.

Mutual fund shares sold without a sales commission payable at the time of purchase (front-end sales load) are commonly referred to as "B shares." B shares typically have an asset-based fee (12b-1 fee) that is charged to the fund over a period of years (12b-1 plan period) and a contingent deferred sales charge (CDSC). The CDSC, sometimes referred to as a back-end load or sales charge, is an asset-based fee charged to investors that redeem B shares during a stated period. This FSP refers to 12b-1 fees and CDSC for shares previously sold collectively as the rights.

The distributor pays a sales commission to a sales representative (usually a broker-dealer) when a B share is sold. The distributor charges the mutual fund a 12b-1 fee in accordance with the fund's distribution plan (12b-1 plan). The distributor is entitled to receive the 12b-1 fee over the 12b-1 plan period (typically six to eight years). If the mutual fund investor redeems its investment in the fund before the expiration of the 12b-1 plan period, the CDSC is charged to the investor. The CDSC declines over time until it reaches zero (typically after six to eight years) and corresponds to the potential shortfall in 12b-1 fees that might result from the investor redeeming its investment in the fund.

The 12b-1 fees are calculated periodically as a percentage of the net assets during the 12b-1 plan period. The CDSC is calculated as a percentage of the lesser of current net assets or the original cost of shares being redeemed. Thus, 12b-1 fees and CDSC vary with the net asset value (NAV) of the fund. Additionally, under Rule 12b-1 of the Investment Company Act of 1940, the fund's independent board is obligated to regularly evaluate the benefits of the 12b-1 plan to the fund. If the board concludes that the 12b-1 plan is no longer beneficial for the fund, the independent board has a fiduciary responsibility to terminate the plan. However, if the 12b-1 plan is continued, but the distributor is replaced, the replaced distributor continues to receive the 12b-1 and CDSC fees for the shares it sold before it was replaced.

Some distributors have received lump sum cash payments from third parties for the rights. These transactions may include certain provisions and indemnities that protect the third party in the event that the 12b-1 plan is terminated by the fund's independent board.

EITF Issue No. 85-24 prohibits distributors from recognizing the rights as revenue until cash is received. This consensus did not address whether the receipt of cash from a third party, that is, a party other than the mutual fund or the investor in the mutual fund, should result in revenue recognition.

FSP No. EITF 85-24-1 provides that revenue recognition is appropriate when cash is received from a third party for the rights if the distributor has neither continuing involvement with the rights nor recourse. Deferred costs for the shares sold to which the rights pertain should be expensed concurrent with the recognition of revenue consistent with the requirements of EITF Issue No. 85-24.

The FASB staff believes that the condition described above, of neither continuing involvement nor recourse, is met when neither the distributor nor any member of the consolidated group that includes the distributor (1) retains any disproportionate risks or rewards in the cash flows of the rights that are sold; (2) guarantees or assures in any way the purchaser's rate of return or return on investment related to the rights that are sold; or (3) contractually restricts the ability of the consolidated group or the mutual fund independent board to remove, replace, or subcontract any of the service providers of the fund.

The FSP provides detailed guidance on continuing involvement in paragraphs 20 through 25 and on recourse in paragraphs 26 through 28.

The guidance in this FSP is effective for reporting periods beginning after March 11, 2005. You can access the FSP at www.fasb.org/fasb_staff_positions/fsp_eitf85-24-1.pdf.

EITF Issue No. 04-5 and FSP No. SOP 78-9-1

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

At the June 15–16, 2005, meeting, 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 consensus provides a framework for addressing when a general partner, or general partners as a group, controls a limited partnership or similar entity. The EITF acknowledged that the consensus in Issue No. 04-5 conflicts with certain aspects of SOP 78-9. The EITF agreed that the assessment of whether a general partner, or the general partners as a group, controls a limited partnership should be consistent for all limited partnerships, irrespective of the industry within which the limited partnership operates. Accordingly, the EITF requested and the FASB agreed to amend the guidance in SOP 78-9 to be consistent with the consensus in Issue No. 04-5.

FSP No. SOP 78-9-1, *Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5*, issued in July 2005, amends SOP 78-9. This FSP eliminates the concept of "important rights" in paragraph .09 of SOP 78-9 and replaces it with the concepts of "kick-out rights" and "substantive participating rights" as defined in Issue No. 04-5. This FSP also amends paragraph .07 of SOP 78-9 to be consistent with revised paragraph .09. The FASB believes that the effect of the rights held by minority partners on the assessment of control, and therefore consolidation, of a general partnership should be the same as the evaluation of limited partners' rights in a limited partnership.

FSP No. SOP 78-9-1 and EITF 04-5 are effective after June 29, 2005, for general partners of all new partnerships formed and for existing partnerships for which the partnership agreements are modified. For general partners in all other partnerships, the guidance is effective no later than the beginning of first reporting period in fiscal years beginning after December 15, 2005.

Please refer to www.fasb.org/fasb_staff_positions/fsp_sop78-9-1.pdf for the complete FSP No. SOP 78-9-1.

FSP No. FAS 140-2

The FASB staff received inquiries regarding the application of paragraph 40 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, to scenarios in which the amount of the passive derivative exceeds the amount of beneficial interests held by third parties due to:

- Unexpected prepayment of the qualifying special-purpose entity's (SPE) assets, or
- Trading and market-making activities conducted by the transferor or its affiliates.

Constituents encouraged the FASB to clarify whether the guidance in paragraphs 40(b) and 40(c) are tests that must be complied with upon initial issuance of the beneficial interests by the qualifying SPE or are tests that are required to be met on a continuous basis.

On November 9, 2005, the FASB issued FSP No. FAS 140-2, *Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140*, to clarify that the accounting guidance provided in paragraphs 40(b) and 40(c) of FASB Statement No. 140 relative to the notional amount of passive derivative instruments held by qualifying SPEs, is required to be met upon initial establishment of the qualifying SPE only. Specifically, the FSP stipulates that (a) unexpected subsequent events outside the control of the transferor, such as prepayments of assets of the qualifying SPE, that were not contemplated when the beneficial interests of the qualifying SPE were issued will not harm the qualified status of the qualifying SPE and (b) purchases of previously issued beneficial interests by a transferor from outside parties that are held temporarily and are classified as trading securities will not be considered when determining whether the requirements of paragraphs 40(b) and 40(c) are met.

Please refer to www.fasb.org/fasb_staff_positions/fsp_fas140-2.pdf for a complete text of this FSP.

On the Horizon

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

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

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

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

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

FASB Fair Value Measurements Project

In June 2004, the FASB published an exposure draft of a proposed Statement, *Fair Value Measurements* (FVM). The overall project objective is to develop a Statement that will define fair value and establish a framework for applying the fair value measurement objective in GAAP. The Statement will focus on "how" to measure fair value, not "what" to measure at fair value. The FASB plans to separately consider what to measure at fair value on a project-by-project basis. The standard will affect the recognition and disclosure of items already required to be measured at fair value. A working draft of the final FVM Statement is available on the FASB Web site http://www.fasb.org/project/fvm_working_draft_standard.pdf for a 30-day period that ended November 21, 2005.

Last year's securities industry Audit Risk Alert discussed certain provisions of the FVM exposure draft. Since the issuance of the exposure draft, the FASB discussed this project on numerous occasions. Below is a brief discussion of some of the developments in connection with this project that took place over the past year that should be of interest to broker-dealers and their auditors.

Fair Value Hierarchy

The FVM Statement establishes a fair value hierarchy, which ranks the inputs to valuation techniques used to estimate fair value to provide a framework for assessing the relative reliability of the estimate. In general, the more market inputs, the more reliable the estimate. Therefore, the fair value hierarchy gives the highest ranking to market inputs that represent quoted prices for identical assets or liabilities in active (liquid) markets (Level 1) and the lowest ranking to entity inputs that represent an entity's own internally derived estimates and assumptions (Level 5).

Level 1 Inputs. The FVM exposure draft referred to the use of quoted prices for *identical* assets or liabilities in active markets in which the entity could actually transact for the asset or liability "as is" at the measurement date. The ability to currently access a Level 1 reference market is important. Because within Level 1 a quoted price for an identical asset or liability (as-is) represents the sole input used for the estimate, it limits discretion in pricing the asset or liability.

Level 2 Inputs. The FVM exposure draft referred to quoted prices for similar assets or liabilities in active markets, adjusted for differences between the asset or liability being measured and other similar assets or liabilities that are "objectively determinable." In its redeliberations, the FASB reconsidered Level 2 inputs. To more clearly convey a continuum of inputs, the FASB decided to broaden Level 2 by (1) including quoted prices for all similar assets or liabilities, whether those prices are quoted in active (liquid) markets or in thin (illiquid) markets, and (2) removing the objectively determinable criterion, requiring adjustments based on other market inputs that reflect the assumptions and data that marketplace participants would use in their estimates.

Level 3 Inputs. The FVM exposure draft included within a single Level 3 all other market inputs together with entity inputs. To more clearly convey a continuum of inputs, the FASB expanded the levels within the hierarchy to more clearly convey the inputs within Level 3. Level 3, as clarified, refers to direct market inputs, that is, observable inputs that relate directly to the asset or liability. Those inputs include information about interest rates, yield curves, volatilities, prepayment speeds, default rates, loss severities, credit risks, and liquidities.

Level 4 Inputs. Level 4 refers to market-based inputs that include extrapolated or interpolated measures that are corroborated through correlation with other market data.

Level 5 Inputs. Level 5 refers to entity inputs that represent an entity's own internal estimates and assumptions. Those inputs are used as a practical expedient in the absence of market inputs.

Pricing in Active Dealer Markets

In its redeliberations, the FASB reconsidered some aspects of the related guidance within Level 1, including guidance provided for bid/asked spread estimates. In situations in which the price for the asset or liability in an active market is quoted in terms of bid and asked prices (for example, in an active dealer market), the FVM exposure draft prescribed the use of bid prices for long positions (assets) and asked prices for short positions (liabilities). In its redeliberations, the FASB reconsidered that bid/asked spread pricing method. Instead, the FASB decided to emphasize the valuation objective and allow a pricing method within the bid/asked spread that provides the best estimate of an exchange-equivalent price in the circumstances within all levels of the fair value hierarchy. Methods generally appropriate under SEC ASR 118 are generally appropriate under the FVM Statement. Those methods include (1) bid prices for assets and asked prices for liabilities, (2) average prices using bid prices, bid and asked prices, or a representative selection of broker-dealer quotes for a particular security, and (3) a valuation within the bid/asked spread considered to best represent an exchange-equivalent price in the circumstances.

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

The FVM exposure draft specified that the estimate should consider the effect of the entity's credit standing so the estimate reflects the amount that would be observed in an exchange between marketplace participants of comparable credit standing.

Many respondents raised related issues in the context of liability remeasurements at fair value. In particular, respondents referred to the "counterintuitive" and confusing reporting that results when changes in an entity's credit standing are included in liability remeasurements at fair value ("losses" for credit upgrades and "gains" for credit downgrades).

In its redeliberations, the FASB affirmed that conceptually, credit standing is an essential component of a fair value measurement. A measurement that does not consider the effect of the entity's credit standing is not a fair value measurement. Therefore, the estimate should consider the effect of the entity's credit standing so that the estimate reflects the amount that would be observed in an exchange between marketplace participants of comparable credit standing at initial recognition and in all subsequent periods in which the liability is measured at fair value. The FASB further clarified that in determining the effect of its credit standing on the estimate of fair value, the entity should consider the terms of any collateral and other credit enhancements included in the contract for the liability being measured.

The FASB agreed, however, that for liability remeasurements at fair value, the credit standing concept raises practical concerns. The FASB plans to separately consider those issues.

Measurement of Blocks

For a large position of unrestricted securities that trades in an active market (block), other FASB Statements (for example, FASB Statements No. 107, *Disclosures about Fair Value of Financial Instruments*; No.115, *Accounting for Certain Investments in Debt and Equity Securities*; No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*; and No. 133, *Accounting for Derivative Instruments and Hedging Activities*), prohibit an estimate of fair value using a blockage factor, that is, a discount (or premium) based on the size of the position relative to trading volume. Those FASB Statements require an estimate of fair value determined as the product of the quoted price of an individual trading unit times the quantity held (PxQ), even if a market's normal trading volume for one day is not sufficient to absorb the quantity held and placing orders to sell (liquidate) the position in a single transaction might affect the quoted price.

For blocks held by broker-dealers and certain investment companies (those that used blockage factors in financial statements for fiscal years ending on or before May 31, 2000), the AICPA Audit and Accounting Guides for broker-dealers and investment companies allowed an exception, permitting an estimate of fair value using a blockage factor. In developing this Statement, the FASB addressed that inconsistency, considering the earlier work completed by the AICPA Accounting Standards Executive Committee (AcSEC) through its Blockage Factor Task Force.

In the FVM exposure draft, the FASB decided to allow the exception for broker-dealers and certain investment companies under the AICPA Audit and Accounting Guides. However, in its redeliberations, the FASB decided to require an estimate using PxQ, thereby prohibiting the use of blockage factors by all entities. In reaching that decision, the FASB affirmed its conclusions in other FASB Statements (including Statement 107). In that regard, the FASB emphasized that basing the fair value on a quoted price in an active market, regardless of the size of the position held, results in comparable reporting. Therefore, this Statement effectively nullifies the related guidance (removes the exception) in the AICPA Audit and Accounting Guides for broker-dealers and investment companies.

Disclosures

The FASB revised aspects of the proposed disclosure requirements as follows:

a. For each major category of assets and liabilities remeasured at fair value during the period, the disclosures should segregate fair value amounts into three disclosure levels, that is, fair value amounts at the end of the period determined using quoted prices for identical assets or liabilities (Level 1), direct market inputs (Level 2 and Level 3), and indirect inputs (Level 4 and Level 5), and include information about the valuation techniques used. The FASB eliminated the related guidance in paragraph 8 of the FVM exposure draft, which would have required that those valuation techniques be consistently applied. Instead, the FASB decided to emphasize the valuation objective, that is, to use the valuation technique(s) that provide the best estimate of fair value in the circumstances.

b. Total gains or losses (unrealized and realized) should be disclosed for each major category of assets and liabilities remeasured at fair value during the period, segregating amounts included in earnings and in other comprehensive income. Unrealized gains or losses related to those assets and liabilities still held at the reporting date should be separately disclosed for each disclosure level below Level 3.

c. Quantitative disclosures using a tabular format are required for interim and annual periods. Other disclosures (for example, information about the valuation techniques used) are required for annual periods only.

d. The fair value information disclosed under the FVM Statement should include the fair value information disclosed under FASB Statement No. 107 and other pronouncements in the periods in which those disclosures are required, if practicable.

Effective Date

The FVM Statement would be effective for financial statements issued for fiscal years beginning after December 15, 2006, except as follows. The fair value disclosures required by the FVM Statement would be effective for financial statements issued for fiscal years ending after December 15, 2006. Earlier application is encouraged.

The provisions of the FVM Statement should be initially applied prospectively, except as follows. For large positions of unrestricted securities with quoted prices in active markets (blocks), the provisions of the FVM Statement should be initially applied retrospectively to all prior periods (a "full" retrospective transition approach). The cumulative effect of the change in accounting principle on periods before those presented should be reflected in the carrying amounts of the related assets and liabilities as of the beginning of the first period presented. An offsetting adjustment should be made to the opening balance of retained earnings for that period. The disclosures for a change in accounting principle in FASB Statement No. 154, *Accounting Changes and Error Corrections*, are required.

Proposed FSP FAS 133-a

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," applies to certain derivative instruments that are measured at fair value under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. In particular, it focuses on transactions that involve any long-dated, over-the-counter derivative investment in an illiquid market.

An issue addressed in EITF Issue No. 02-3 is how to estimate the fair value of the derivative instrument at the inception of the contract (initial recognition). Issue No. 02-3, in effect, focuses that issue on whether the estimate should be based on (a) the transaction price, that is, the price (or rate) for the derivative instrument in the market in which the entity and the counterparty transact or (b) a model value that represents an estimate of the price (or rate) for the derivative instrument in the most advantageous market in which the entity could transact, even if that market does not currently exist (it is hypothetical).

The FASB staff guidance in Issue No. 02-3 specifies that the transaction price should be used to estimate the fair value of the derivative instrument unless an estimate determined by the entity (generally, a model value) is derived principally from observable market inputs. Footnote 3 to Issue No. 02-3 states:

> The FASB staff believes that, in the absence of (a) quoted market prices in an active market, (b) observable prices of other current market transactions, or (c) other observable data supporting a valuation technique, the transaction price represents the best information available with which to estimate fair value at the inception of the arrangement. Therefore, in the FASB

> staff's view an entity should not recognize an unrealized gain or loss at inception of a derivative instrument unless the fair value of that instrument is obtained from a quoted market price in an active market or is otherwise evidenced by comparison to other observable current market transactions or based on a valuation technique incorporating observable market data. For example, a valuation technique that includes extrapolated price curves with little or no observable market inputs for any significant duration of the instrument should not result in an initial fair value estimate that differs from the transaction price for the instrument taken as a whole, because, in this example, the transaction price is the best evidence of the instrument's fair value at that point in time.

A related issue is when an unrealized gain (loss) (also referred to as dealer profit (loss)), measured as the difference between the transaction price and the estimate at initial recognition, should be recognized. EITF Issue No. 02-3 does not address that issue. As a result, practice is diverse with regard to both the method and timing of recognition. For example, some entities recognize the unrealized gain (loss) in income when the estimate is derived principally from observable market inputs (generally at or near the end of the contract). Other entities amortize the difference into income over the term of the derivative instrument.

Respondents to the June 2004 exposure draft of a proposed FASB Statement, *Fair Value Measurements*, raised issues with regard to the proposed guidance and its interaction with the related FASB staff guidance in EITF Issue No. 02-3. In June 2005, the FASB decided to add a separate project to its agenda to address those issues in the context of its tentative decisions reached in redeliberations of the exposure draft.

On October 21, 2005, the FASB issued proposed FSP FAS 133-a, "Accounting for Unrealized Gains (Losses) Relating to Derivative Instruments Measured at Fair Value under Statement 133," which would nullify the FASB staff guidance included in footnote 3 to EITF Issue No. 02-3. It would not affect the consensuses reached by the EITF in Issue No. 02-3. This FSP also would amend Statement 133 Implementation Issue No. B6, "Allocating the Basis of a Hybrid Instrument to the Host Contract and the Embedded Derivative."

The Derivative Instrument—Initial Fair Value

Derivative instruments subject to the requirements of Statement 133 should be measured at fair value at initial recognition and in all subsequent periods. Consistent with the definition of *fair value* (as revised in the FVM project), the fair value of a derivative instrument should reflect the best estimate of the price (or rate) for the derivative instrument in the most advantageous market in which the entity could transact (referred to as the *reference market*).

In the FVM project, the FASB affirmed that the price in an actual transaction for an asset or liability involving the entity is presumed to reflect the fair value of the asset or liability at initial recognition, absent persuasive evidence to the contrary. In that context, for a transaction involving a derivative instrument:

a. The transaction price presumption is not rebutted at initial recognition of the derivative instrument if the market in which the transaction occurs is the reference market for the derivative instrument. That would often be the case if the entity is the purchaser of the derivative instrument (the customer). In that case, the estimate of the fair value of the derivative instrument shall be the price in that market (the transaction price).

b. The transaction price presumption is rebutted at initial recognition of the derivative instrument if the market in which the transaction occurs (for example, a retail market) is not the reference market for the derivative instrument. That would be the case if the entity would transact in a more advantageous market for the derivative instrument (for example, a dealer market). In that case, the estimate of the fair value of the derivative instrument shall be the price in the reference market for that derivative instrument (generally, a model value).

Unrealized Gain (Loss)

If the transaction price presumption is rebutted at initial recognition of the derivative instrument, an unrealized gain (loss), measured as the difference between the transaction price and the estimate of the fair value of the derivative instrument, shall be recognized in income when a minimum reliability threshold is met for the estimate. If the transaction price presumption is not rebutted at initial recognition of the derivative instrument, the transaction price and the estimate of the fair value of the derivative instrument should be the same. Therefore, there is no unrealized gain (loss). The minimum reliability threshold is met if the estimate falls within Levels 1 to 4 of the fair value hierarchy as described in the FVM Statement. Therefore:

a. If the minimum reliability threshold is met for the estimate at initial recognition of the derivative instrument, an unrealized gain (loss) shall be recognized in income.

b. If the minimum reliability threshold is not met for the estimate at initial recognition of the derivative instrument, an unrealized gain (loss) shall be recognized as a deferred credit or debit, separate from the derivative instrument. An unrealized gain (loss) that is deferred shall be recognized in income when the minimum reliability threshold for the estimate is met (or when the contract expires due to maturity or exercise). An unrealized gain (loss) that is deferred shall not be amortized into income or recorded in equity.

Fair Value Estimates in Subsequent Periods

In subsequent periods, changes in the fair value of the derivative instrument shall be recognized in income (or other comprehensive income) in accordance with the provisions of FASB Statement No. 133. For purposes of recognizing changes in the fair value of the derivative instrument in subsequent periods, the minimum reliability threshold described above does not apply.

Example

The proposed guidance above is illustrated by reference to the following simplified example in which a derivatives dealer (entity) executes a derivative transaction (for example, a customized swap) with a retail customer.

The transaction price is $0, the model value is $2, and the transaction price presumption is rebutted. Therefore, dealer profit is $2. The model value is derived principally from entity-based inputs (a Level 5 estimate). In that case, the entity would recognize a derivative asset of $2 based on the model value and defer the dealer profit of $2 (as a deferred credit), separate from the derivative.

In a subsequent period, the model value increases to $5. The model value continues to be derived principally from entity-based inputs (a Level 5 estimate). In that case, the entity would increase the derivative asset to $5 based on the model value and recognize the change in fair value (of $3) in earnings. The entity would continue to defer the dealer profit (of $2) until the model value meets the minimum reliability threshold (a Level 4 estimate).

Disclosures

Under the proposed FSP, an entity shall disclose the following information:

a. Gross unrealized gains and losses at initial recognition of a derivative instrument recognized in income during the current period.

b. Gross unrealized gains and losses at initial recognition of a derivative instrument that are deferred in the statement of financial position, and a reconciliation of the beginning and ending deferred balance(s) during the period, indicating where in the statement of financial position the deferred amounts are reported.

In subsequent periods, the disclosures in FVM Statement shall apply.

Amendment of FASB Statement No. 133 Implementation Issue No. B6

The proposed FSP would amend FASB Statement No. 133 Implementation Issue No. B6, *Allocating the Basis of a Hybrid Instrument to the Host Contract and the Embedded Derivative*, to clarify that for a hybrid instrument with an embedded derivative that would be subject to the proposed FSP if that derivative were free-standing, a dealer profit component should be separately recognized in accordance with the provisions of the proposed FSP, that is, separately recognized in earnings or as a deferred credit (debit), depending on where within the hierarchy the estimate of fair value falls.

Effective Date

The proposed FSP shall be effective for financial statements issued for fiscal years beginning after December 15, 2006, and interim periods within those fiscal years. Earlier application is encouraged, but only if the FASB FVM Statement has been applied. The proposed FSP shall be applied retrospectively as of the beginning of the fiscal year in which this FSP is initially applied. An offsetting adjustment, if any, shall be made to the opening balance of retained earnings for that fiscal year. In the fiscal year in which this FSP is initially applied, and in all interim periods within that fiscal year, an entity shall disclose the effect of the change in accounting principle on income before extraordinary items and any affected per-share amounts, if applicable (FASB Statement No. 154, *Accounting Changes and Error Corrections*, paragraphs 17(b)(2) and 18).

Please refer to www.fasb.org/fasb_staff_positions/prop_fsp_fas133-a.pdf for a complete text of the proposed FSP.

Exposure Drafts Related to FASB Statement No. 140

On August 11, 2005, the FASB issued three exposure drafts that are discussed below. All three proposed Statements would amend FASB Statement No. 140. The exposure draft on certain hybrid financial instruments also would amend FASB Statement No. 133. These exposure drafts make significant changes in the accounting for transfers of financial assets, servicing of financial assets, and the accounting for certain hybrid instruments. Comments were due on October 10, 2005.

Accounting for Transfers of Financial Assets

This exposure draft is a revision of the June 2003 exposure draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets*. The revised exposure draft reflects what the FASB learned from constituents' comments in the earlier effort and deals with some new issues.

Specifically, the revised 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.

You can access this exposure draft at www.fasb.org/draft/rev_ed_qspe_amend_st140.pdf and get updated information on the status of this project at www.fasb.org/project/qualifying_spe.shtml.

Accounting for Servicing of Financial Assets

This exposure draft would amend FASB Statement No. 140 with respect to the accounting for separately recognized servicing rights. The FASB added this project to its agenda in response to constituents' requests to simplify the accounting and to mitigate the effect of having different measurement attributes for related financial instruments.

Specifically, the proposed Statement would (a) require all separately recognized servicing rights to be initially measured at fair value, if practicable, (b) permit an entity to choose between two measurement methods for each class of separately recognized servicing assets and liabilities, and (c) require additional disclosures for all separately recognized servicing rights.

You can access this exposure draft at www.fasb.org/draft/ed_servicing_financial_assets_amend_st140.pdf and get updated information on the status of this project at www.fasb.org/project/servicing_ rights.shtml.

Accounting for Certain Hybrid Financial Instruments

This exposure draft would amend FASB Statements No. 133 and No. 140 to eliminate a temporary exemption from FASB Statement No. 133 for certain securitized interests and to simplify the accounting for hybrid instruments.

Specifically, the proposed Statement would (a) permit fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (b) clarify which interest-only strips and principal-only strips are not subject to the requirements of FASB Statement No. 133, (c) establish a requirement to evaluate beneficial 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, (d) clarify that concentrations of credit risk in the form of subordination are not embedded derivatives, and (e) eliminate restrictions on a qualifying SPE's ability to hold passive derivative financial instruments that pertain to beneficial interests that are themselves or that contain a derivative financial instrument.

You can access this exposure draft at www.fasb.org/draft/ed_hybrid_financial_instruments.pdf and get updated information on the status of this project at www.fasb.org/project/hybrid_financial_instruments.shtml.

EITF Issue No. 04-7 and Proposed FSP No. FIN 46(R)-c

FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*, provides guidance on how to apply the controlling financial interest criteria in AICPA Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, to variable interest entities (VIEs). VIEs are evaluated for consolidation based on all contractual, ownership, or other interests that expose their holders to the risks and rewards of the entity. These interests are termed variable interests. An integral part of applying FASB Interpretation No. 46(R) is determining whether interests are variable interests. Constituents have raised concerns that FASB Interpretation No. 46(R) is unclear about how an entity should determine whether a contract absorbs variability. Different approaches for making this determination have developed, which results in inconsistent identification of interests as variable interests. These inconsistencies can have a significant impact on the determination of which party should consolidate the VIE. The issue is what variability should be considered when determining whether an interest is a variable interest.

To address this issue, in May 2004 the EITF added Issue No. 04-7, "Determining Whether an Interest is a Variable Interest in a Potential Variable Interest Entity," to its agenda. Throughout its deliberations, the EITF has acknowledged that both cash flow and fair value variability can be significant when determining whether an interest is a variable interest. However, the EITF struggled with the conceptual basis as to when it is appropriate to consider one type of variability instead of the other.

At the March 17, 2005, meeting the EITF observed that guidance would be needed from the FASB to determine how the design of the entity would be used to determine the variability to be considered. At its March 30, 2005, meeting the FASB agreed to provide such guidance in the form of an FSP.

On September 29, 2005, a proposed FSP FIN 46(R)-c, "Determining the Variability to Be Considered In Applying FASB Interpretation No. 46(R)," that addresses determining the variability to be considered when applying FASB Interpretation No. 46 (revised December 2003) was issued for public comment. The proposed FSP recognizes that there currently is diversity in practice with respect to determining the variability to consider when applying FASB Interpretation No. 46(R). The proposed FSP outlines, in principle, a systematic process for analyzing the design of the VIE or potential VIE to determine the purpose of the entity and the risks and variability the entity was designed to create and pass along to its interest holders. Examples are included to illustrate how that process would be applied to specific transactions.

The guidance in the final FSP would be effective prospectively from the date the FSP is posted to the FASB Web site for new initial determinations of whether an entity is a VIE (including newly created entities). In addition, the guidance would be effective for all entities previously analyzed under FASB Interpretation No. 46(R) for which a reconsideration event as to whether an entity is a VIE occurs pursuant to paragraph 7 of FASB Interpretation No. 46(R) after the effective date. Early application also would be permitted for periods for which financial statements have not yet been issued. Retroactive application to the date of the initial application of FASB Interpretation No. 46(R) would be permitted but not required. Retrospective application, if elected, must be completed no later than the first interim or annual reporting period ending after April 15, 2006.

A 60-day public comment period for this proposed FSP ended November 30, 2005. The final FSP is expected to be issued in the first quarter of 2006.

Please refer to www.fasb.org/fasb_staff_positions/prop_fsp_fin46r-c.pdf for a complete text of the proposed FSP and to www.fasb.org/project/variable_interest.shtml for information on the status of this project.

FASB Fair Value Option Project

In this project, the FASB is considering whether to permit entities a one-time election, at the initial recognition of a contract, to report certain financial instruments (and perhaps similar nonfinancial instruments) at fair value with the changes in fair value included in earnings. The fundamental objectives of this project include the following:

1. To mitigate problems in determining reported earnings caused by the mixed-attribute model (that is, problems related to some assets or liabilities being reported at the fair value measurement attribute, but other related liabilities and assets being reported at another measurement attribute, such as amortized cost).
2. To enable entities to achieve an offset accounting effect for the changes in the fair values of related assets and liabilities without having to apply more complex hedge accounting provisions, thereby providing some potential simplicity in the application of the accounting guidance for this area.

3. To achieve further convergence with the International Accounting Standards Board (IASB), which has incorporated a fair value option for financial instruments in its IAS 39, *Financial Instruments: Recognition and Measurement*.
4. To expand the use of the fair value measurement attribute, particularly for financial instruments.

The FASB decided that no eligibility criteria should be imposed on the election of the fair value option because the broad availability of the fair value option is more consistent with the fundamental objectives of the project.

One of the issues discussed in connection with this project is whether to curtail a debtor's recognizing in earnings the effect of changes in its creditworthiness in reporting liabilities at fair value when the fair value option has been elected. At its October 19, 2005, meeting, the FASB discussed several approaches for possibly curtailing a debtor's recognition of the portion of a liability's changes in fair value that is attributable to changes in its own creditworthiness in conjunction with reporting liabilities at fair value. The FASB rejected any such curtailment of the effect of changes in the debtor's creditworthiness. That decision applies to derivative liabilities reported at fair value under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as well as any other liabilities reported at fair value, such as those for which the fair value option will have been elected.

The FASB also discussed specific disclosures related to liabilities that are reported at fair value and the portion of the fair value change that is attributable to changes in the debtor's creditworthiness. Although the FASB indicated preliminary support for disclosing the difference between the carrying amount of a financial liability and the amount the entity would be contractually required to pay at maturity to the holder of the obligation, no decisions regarding disclosures were made at this time. Instead, disclosures will be addressed comprehensively later in the FASB's deliberations on this project.

The FASB plans to issue an exposure draft in the first quarter of 2006. Please refer to www.fasb.org/project/fv_option.shtml for information on the status of this project.

Proposed SOP, *Clarification of the Scope of the Audit and Accounting Guide* Audits of Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies

At its September 2003 meeting, AcSEC approved for final issuance the SOP *Clarification of the Scope of the Audit and Accounting Guide* Audits of Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies, subject to AcSEC's negative clearance and FASB clearance. At its June 15, 2004, meeting, the FASB did not object to issuance of the SOP, subject to certain revisions. Subsequent to the June 15 clearance meeting, it came to the task force's attention that certain provisions of the draft SOP may include potential unintended consequences. The task force is considering proposing additional revisions to the SOP to address those potential unintended consequences.

Among other things, this SOP will address whether investment company accounting should be retained by a parent company (of an investment company) in consolidation or by an investor (in an investment company) that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the entity. Some practitioners are concerned that the conditions specified in the proposed SOP for determining whether investment company accounting should be retained in the consolidated financial statements of the entity's parent company or an equity method investor are too restrictive. For example, paragraph 30(b) of the proposed SOP provides that to retain investment company accounting in the financial statements of the entity's parent company, the consolidated group (the parent company and its consolidated subsidiaries) should follow established policies that effectively distinguish the nature and type of investments made by the investment company from the nature and type of investments made by other entities within the consolidated group that are not investment companies. Those policies should address, at a minimum, (1) the degree of influence held by the investment company and its related parties over the investees of the investment company, (2) the extent to which investees of the investment company or their affiliates are in the same line of business as the parent company or its related parties, and (3) the level of ownership interest held in the investment company by the consolidated group. The guidance in this condition is intended to prohibit the consolidated group from selectively making investments within an investment company subsidiary that are similar to investments held by noninvestment company members of the consolidated group when those investments would be accounted for by the equity method, by consolidation, or at cost if the investment were made by a noninvestment company member of the consolidated group.

AcSEC expects to issue the final SOP in the first quarter of 2006. Please stay alert to further developments.

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

This Practice Aid provides practitioners with nonauthoritative practical guidance on auditing financial statements of futures commission merchants, introducing brokers, and commodity pools. Organized to complement the Audit and Accounting Guide *Brokers and Dealers in Securities*, this Practice Aid includes an overview of the commodity industry; discussions of regulatory considerations, auditing considerations, and accounting standards; and illustrative financial statements of FCMs, IBs, and commodity pools.

The Commodity Practice Aid Task Force of the AICPA is in the process of revamping this 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.

Auditing Pipeline—Nonpublic Companies

Eight SASs Related to Audit Risk

In October 2005, the AICPA's Auditing Standards Board (ASB) voted out eight SASs related to risk assessment. The ASB believes that the requirements and guidance provided in the SASs would result in a substantial change in audit practice and in more effective audits. The primary objective of the SASs is to enhance auditors' application of the audit risk model in practice by requiring:

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

The eight SASs consist of:

- *Amendment to "Due Professional Care in the Performance of Work" of Statement on Auditing Standards No. 1*, Codification of Auditing Standards and Procedures
- *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards
- *Audit Evidence*
- *Audit Risk and Materiality in Conducting an Audit*
- *Planning and Supervision*
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling

The SASs establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit. Readers should be alert for the issuance of final standards in the first quarter of 2006.

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

This proposed SAS will supersede AU section 325, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1), and significantly strengthen the quality of auditor communications of such matters in audits of nonpublic companies. Readers should be alert for the issuance of a final standard in the first quarter of 2006.

Proposed Statement on Standards for Attestation Engagements, *Reporting on an Entity's Internal Control Over Financial Reporting*

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

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

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

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

Amendment to SAS No. 69, **The Meaning of** *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*

The ASB has issued an exposure draft introducing a proposed SAS entitled *Amendment to Statement on Auditing Standards No. 69*, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to the FASB's proposed Statement of Financial Accounting Standards entitled *The Hierarchy of Generally Accepted Accounting Principles*. The FASB proposal moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69 (AU section 411)) to the accounting literature. The proposed SAS deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The ASB decided to coordinate the provisions and effective date of this exposure draft with the FASB proposed statement, which can be obtained at www.fasb.org.

On the Bookshelf

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

- Audit and Accounting Guide *Brokers and Dealers in Securities* (product no. 012705kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012523kk)
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012515kk)
- Audit Guide *Audit Sampling* (product no. 012530kk)
- Audit Guide *Analytical Procedures* (product no. 012555kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, As Amended* (product no. 012775kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk)
- *Accounting Trends & Techniques—2005* (product no. 009897kk)
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- Practice Aid *Fraud Detection in a GAAS Audit* (product no. 006615kk)

Audit and Accounting Manual

The *Audit and Accounting Manual* (product no. 005135kk) is developed exclusively for small- and medium-size CPA practices. This unique one-volume manual explains and demonstrates useful techniques and procedures for conducting compilation, review and audit engagements—from planning to internal control to accountants' reports.

AICPA reSOURCE Online: Accounting and Auditing Literature

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

Educational Courses

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

- *AICPA's Annual Accounting and Auditing Update Workshop* (2005 edition) (product no. 736181kk, text; also available in video and DVD formats with a manual). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.

- *Fraud and the Financial Statement Audit: Auditor Responsibilities Under SAS 99* (product no. 731812kk, text; for product numbers for other formats please refer to the cpa2biz Web site). The new fraud standard may not change your responsibilities for detecting fraud in a financial statement audit, but it will change how you meet that responsibility. Practitioners will benefit from a risk assessment approach to detecting fraud in a financial statement audit. You will learn the conceptual framework necessary to understand the characteristics of fraud.

- *Auditing for Internal Fraud* (product no. 730274kk). This course provides the auditor with the tools to identify fraud schemes. It trains CPAs to focus their analytical and substantive tests on the fraud triangle when evaluating internal controls. It also illustrates the latest in fraud prevention and detection programs implemented by industry leaders.

- *Identifying Fraudulent Financial Transactions* (product no. 730245kk). Learn to identify the red flags of fraud in financial information and to analyze a variety of fraud schemes. You will develop a framework for detecting financial statement fraud and learn about fraud schemes in revenue, inventory, liabilities, and assets.

- *Independence* (product no. 739170kk). This interactive CD-ROM course reviews the AICPA authoritative literature covering independence standards (including the AICPA SEC practice section independence requirements), SEC regulations on independence, and Independence Standards Board (ISB) standards.
- *SEC Reporting* (product no. 736772kk, text; for product numbers for other formats please refer to the cpa2biz Web site). This course helps the practicing CPA and corporate financial officer learn to apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.
- *Internal Control and IT: Reliable Reporting and Fraud Prevention* (product no. 732550kk). This course will provide an overview of the key auditing standards, conceptual frameworks, IT infrastructures and auditing issues you are likely to face on medium to small company engagements.

For listing of additional courses available please download the *Fall/Winter 2005 AICPA CPE Catalog* at https://media.cpa2biz.com/Publication/05_fall_winter_FINAL.pdf. You can also check at https://www.cpa2biz.com/CPE/default.htm for availability of a more recent catalog.

Online CPE

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

Webcasts

Stay plugged in to what's happening and earn CPE credit right from your desktop. AICPA Webcasts are high-quality two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in on the discussion. If you can't make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

The CFO Roundtable Webcast Series—brought to you each calendar quarter—is designed to cover a broad array of "hot topics" that successful organizations employ and subjects that are important to a CFO's personal success. From financial reporting and budgeting and forecasting, to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

The SEC Quarterly Update Webcast Series—brought to you each calendar quarter—showcases the profession's leading experts on what's "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and CorpFin activities, these hard-hitting sessions will keep you "plugged-in" to what's important. A must for both preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

National Securities Industry Conference

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

Member Satisfaction Center

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

Hotlines

Accounting and Auditing Technical Hotline

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

Ethics Hotline

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

Web Sites

AICPA Online and CPA2Biz

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

Other Helpful Web Sites

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

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This Audit Risk Alert replaces *Securities Industry Developments—2004/05*. The *Securities Industry Developments* Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to ymishkevich@aicpa.org, or write to:

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INFORMATION SOURCES

Organization	*Web Site, Address, Telephone*
American Institute of Certified Public Accountants	www.aicpa.org Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 Telephone: (888) 777-7077
Financial Accounting Standards Board	www.fasb.org Order Department: 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 Telephone: (203) 847-0700
Financial Crimes Enforcement Network (FinCEN)	www.fincen.gov
U.S. Securities and Exchange Commission	www.sec.gov 100 F Street, NE Washington, DC 20549 *Publications Unit* (202) 551-4040 *SEC Public Reference Room* (202) 551-8090
Securities Industry Association	www.sia.com 120 Broadway, 35th floor New York, NY 10271-0080 Telephone: (212) 608-1500
New York Stock Exchange, Inc.	www.nyse.com 11 Wall Street New York, NY 10005 Telephone: (212) 656-3000
National Association of Securities Dealers, Inc.	www.nasd.com 1735 K Street, NW Washington, DC 20006-1500 Telephone: (202) 728-8000
The Bond Market Association	www.bondmarkets.com 360 Madison Avenue New York, NY 10017-7111 Telephone: (646) 637-9200

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

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