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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AUDIT RISK ALERTS

Securities Industry Developments—2006/07

Strengthening Audit Integrity
Safeguarding Financial Reporting

AICPA®

AUDIT RISK ALERTS

Securities Industry Developments — 2006/07

Strengthening Audit Integrity
Safeguarding Financial Reporting

American Institute of Certified Public Accountants

AICPA®

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—2006/07

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—2006/07* (product no. 022337kk).

Economic and Industry Developments

Economic Developments

In 2006, the U.S. economy has shown signs of cooling down. Real gross domestic product (GDP) grew 1.6 percent in the third quarter, which was below the 2.6-percent growth registered in the second quarter and the exceptional 5.6-percent growth in the first quarter. According to the updated economic forecast issued by the White House on November 21, 2006, for the whole year GDP is expected to increase 3.1 percent, which is below the 3.3-percent

growth registered in 2005. Furthermore, economic growth is expected to slow down in 2007 to 2.9 percent.

The federal funds rate incrementally increased 75 basis points throughout 2006 to 5.25 percent as a result of the Federal Reserve combating inflation. However, since late June, the Fed has kept its target federal funds rate steady.

Please refer to the AICPA general *Audit Risk Alert—2006/07* for an in-depth discussion of the United States economic and business environment. For up-to-date information, you may also wish to refer to Web sites of the Federal Reserve branches at http://www.federalreserve.gov/otherfrb.htm. Also, the Boston branch publishes monthly a report on stock market activity which practitioners in the securities industry may find particularly helpful.

The Securities Industry

Notwithstanding the economic slowdown, the stock market has performed well in 2006. On October 19, 2006, the Dow Jones Industrial Average (DJIA) closed above the 12000 level for the first time and since then has continued its stellar performance, posting one record close after another. On November 17, 2006, the Standard & Poor's 500 Index (S&P 500) crossed the 1400 mark for the fist time in six years. The National Association of Securities Dealers Automated Quotation (NASDAQ) composite index has also been increasing and it has more than doubled since its October 2002 low of 1114.11.

2006 is expected to be an exceptional year for the securities industry. According to the Securities Industry and Financial Markets Association (SIFMA),[1] for the first half of 2006, US securities industry profits reached $15.3 billion, the best half-year performance in six years. The SIFMA estimates that the industry profits reached $7.25 billion in 3Q'06, down only slightly from the $7.5 billion earned in 2Q'06 and $7.82 billion reported in

1. SIFMA was formed as a result of the merger between the Securities Industry Association and the Bond Market Association.

1Q'06. For the year 2006 as a whole, the SIFMA expects profits to top $28.5 billion, $10.9 billion higher than in 2005, and easily surpassing the industry's second best annual performance of $25.3 billion set in 1999, but still short of the record $31.6 billion earned in 2000. Total revenues in 2006 are expected to top $414.8 billion, an increase of 28.9 percent from the 2005 results. More importantly, net revenues (total revenues net of interest expense) are forecast to reach $211.5 billion, up 13.9 percent from last year's level.

For more information, please refer to the September and November 2006 issues of the SIFMA Research Reports (Vol. VII, No.10 and Vol. I, No. 1, respectively), which can be accessed at http://www.sia.com/research/html/research_reports.html.

The Commodities Industry

Global futures and options contract volume has continued to increase through 2005 and into 2006. In the first eight months of 2006, volume on U.S. futures exchanges reached 3 billion contracts, a 34-percent increase from the same period in 2005. The volume of contracts traded on foreign exchanges increased 18.5 percent compared to the first eight months of 2005. These changes are primarily attributable to increased trading volume in interest rate and equity products.

The growth in futures volume and markets is further reflected in increased customer funds held by entities registered with the Commodity Futures Trading Commission (CFTC) as futures commission merchants (FCMs) for trading on U.S. and foreign futures and options exchanges. The total amounts required under CFTC regulations to be held in segregated or secured accounts on behalf of FCM customers increased from approximately $105 billion as of June 30, 2005, to more than $137 billion as of June 30, 2006, an increase of more than 30 percent.

The U.S. futures industry, in addition to the increasing volume and customer participation, has also experienced other significant changes through 2005 and into 2006. In October 2006, the Chicago Mercantile Exchange (CME) and the Chicago Board of

Trade (CBOT), the two largest contract markets designated by the CFTC, announced merger plans, subject to appropriate regulatory and stockholders' approval. The new CME/CBOT combined organization, to be called CME Group, Inc., would be U.S.-based and devoted to derivatives trading and clearing.

Regulatory Issues and Developments[2]

Chapter 5, "Auditing Considerations," of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* (the Broker Dealer Guide), discusses auditing considerations for an audit of the financial statements of a broker-dealer. The Broker Dealer 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 introducing brokers (IBs) are specified by Regulation 1.16 of the Commodity Exchange Act. Alternative regulatory frameworks have been created for Consolidated Supervised Entities and over-the-counter derivatives dealers. Further, registered broker-dealers in U.S. Government securities are regulated by Section 405.02 of the regulations pursuant to Section 15C of the Exchange Act.

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.

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.

Portfolio Margining

New York Stock Exchange (NYSE or the Exchange) Rule 431, *Margin Requirements*, generally prescribes minimum initial and maintenance margin requirements. On July 14, 2005, the Securities and Exchange Commission (SEC) approved, on a pilot basis expiring July 31, 2007, amendments to Rule 431 to permit the application of a prescribed risk-based margin requirement (portfolio margin) to certain eligible products (including listed broad-based securities index options, warrants, futures, futures options, and related exchange traded funds) as an alternative to strategy-based margin requirements. Amendments to Rule 726, Delivery of Options Disclosure Document and Prospectus, were also approved requiring disclosure to and written acknowledgment from customers in connection with the use of portfolio margin. For more information, please refer to SEC Release No. 34-52031 and NYSE Information Memo No. 05-56. By separate orders, the SEC also approved a parallel rule filing by the Chicago Board Options Exchange (CBOE), and a related rule filing by the Options Clearing Corporation (OCC). See SEC Releases No. 34-52032 and No. 34-52030.

On July 11, 2006, the SEC approved additional amendments to Rule 431 that:

1. Expanded the scope of products eligible for portfolio margining and cross-margining; and
2. Conformed customer disclosure requirements under Rule 726 to comply with this expansion; and
3. Modified certain net capital requirements in connection with the maintenance of portfolio margin accounts.

Collectively, these amendments are referred to as the *expanded pilot*. The expanded pilot expanded the scope of products eligible for portfolio margining and cross-margining to include listed security futures and listed single stock options. Further, the expanded pilot permitted pilot program participants to effect transactions solely in security futures and listed single stock options without maintaining the $5 million equity requirement applicable to effecting transactions in all other eligible products. See SEC Release No. 34-54125 and NYSE Information Memo No. 06-57 for more information.

On December 12, 2006, the SEC approved additional amendments to NYSE Rule 431 that permit the application of portfolio margin to an expanded universe of eligible products. In addition, amendments to NYSE Rule 726 eliminate the sample portfolio margining risk disclosure statement from the Rule. However, the Rule will continue to require member organizations to provide customers with a written disclosure statement in a form prescribed by the Exchange, as well as to receive from customers a signed acknowledgement, in a form to be published at a later date. The amendments are effective April 2, 2007. See SEC Releases No. 34-54918 and NYSE Information Memo No. 06-86 for more information.

Also, on December 12, 2006, the SEC approved a rule change proposed by the CBOE, as amended, to broaden its Rule 12.4, *Portfolio Margin and Cross-Margin for Index Options*, to expand the scope of products that are eligible for treatment as part of CBOE's approved portfolio margin pilot program and to eliminate the requirement for a separate cross-margin account. The scope of eligible products in the pilot is expanded to include margin equity securities, unlisted derivatives, listed options and securities futures. See SEC Release No. 34-54919 for more information.

Portfolio margining is a margin methodology that sets margin requirements for an account based on the greatest projected net loss of all positions in a "security class" or "product group" as determined by a theoretical pricing model using multiple pricing scenarios. The goal of portfolio margining is to set levels of margin

that more precisely reflect actual net risk. The eligible participant benefits from portfolio margining in that margin requirements calculated on net risk are generally lower than alternative *position-* or *strategy-based* methodologies for determining margin requirements. Lower margin requirements allow the customer more leverage in an account. Broker-dealers will benefit from portfolio margining because it recognizes a greater number of offsets than was permitted under the previously required strategy-based margin rules and is expected to result in lower margin requirements. However, under the new rules, broker-dealers would be required to actively manage the risk in portfolio margin accounts.

As specified in NYSE Information Memo 06-86, member organizations, for which the Exchange is the Designated Examining Authority (DEA), seeking to participate in portfolio margin must provide written notification and receive approval from the Exchange prior to establishing a portfolio margin methodology. In this regard, member organizations are expected to establish written procedures for monitoring the risk associated with portfolio margin accounts; such procedures must incorporate a methodology for assessing any potential risk to the member organization's capital. As previously discussed in Information Memo 06-57, the procedures must be fully documented and should address, at minimum, the following:

- Opening of portfolio margin accounts
- The profile of customers who will be eligible for portfolio margining, including the initial approval process to be applied
- A description of minimum equity requirements for each customer
- The determination, review, and approval of credit limits for each customer and across all customers
- A description of any internal model used to determine risk in individual customer accounts, including the documentation for this model

- A description of correlation assumptions included in any internal models used for assessing the adequacy of margin in a customer's account
- A description of the stress testing scenarios that are performed on the accounts, and provide the frequency of such testing and the results of the most recent stress test
- Monitoring of accounts to ensure that the account contains a portfolio of hedged instruments
- Identification of security concentrations within an account
- Identification of concentrations in individual securities across customer accounts
- Intraday monitoring of exposure in customer accounts
- Detection, prevention, and circumvention of day trading requirements
- Monitoring of limitation on credit extended on portfolio margining to 1,000 percent of the member organization's net capital
- A description of the process for obtaining the TIMS theoretical valuation points and the process used to compute margin requirements in individual customer accounts
- A description of house margin requirements if they differ from the TIMS requirement
- A description of exception reports that will be utilized to monitor margin exposure
- A description of the escalation procedures to alert senior management of unusual risks
- The regular review and testing of the risk analysis procedures by an independent unit such as internal audit or other comparable group
- If an organization would like to provide portfolio margining to customers in unlisted derivatives, the application should include a description of the products as well as a

detailed description of the credit analysis and collateral management process that will be utilized to monitor any exposure that may result to the broker-dealer. This information may be submitted at a later date if unlisted derivatives are not being offered to customers on the implementation date

Member organizations seeking approval to participate in portfolio margining must submit all relevant supporting documentation to their finance coordinator. Such documentation must be accompanied by an organization chart identifying those persons primarily responsible for portfolio margin risk management and the person or persons to whom they report.

In order for member organizations to be approved by the effective date of April 2, 2007, written notifications must be submitted no later than February 15, 2007.

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

The concept of outsourcing is not new to the securities industry. Introducing broker-dealers have long been permitted 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. 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.

NYSE Proposed Rule

NYSE Rule 382 has allowed for the delegation of both functions *and* responsibilities to a clearing firm, and accordingly, it has required 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. On March 16, 2005, the NYSE filed with the SEC a proposed new rule, Rule 340, which would govern conditions to be satisfied in connection with outsourcing arrangements between members/member organizations and various service providers.

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

Notice to Members 05-48. In July 2005, National Association of Securities Dealers (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), Municipal Securities Rulemaking Board (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.

Interpretive Letter. In addition, on August 15, 2006, the NASD issued an Interpretive Letter that provides responses to questions regarding the scope of the guidance provided in Notice to Members 05-48 (NtM 05-48 or the Notice). According to the Letter, NtM 05-48 is not intended as guidance regarding the appropriateness of outsourcing a particular activity or whether an activity may or may not be outsourced to a nonbroker-dealer third-party service provider. Rather, the purpose of NtM 05-48 was to clarify a member's responsibilities if the member outsources *covered activities* which the Notice identifies as activities or functions that, if performed directly by members, would be required to be the subject of a supervisory system and written supervisory procedures pursuant to NASD Rule 3010. To help members understand the meaning of the term "covered activities," the Notice provided a short, nonexhaustive list of examples as a reference.

As identified in NtM 05-48, the primary responsibility for any member outsourcing covered activities is to include procedures regarding its outsourcing practices in its supervisory system and written supervisory procedures to ensure compliance with applicable securities laws and regulations and NASD rules. In addition, because a member has a continuing responsibility to oversee, supervise, and monitor the service provider's compliance performance of covered activities, the member must have in place specific policies and procedures to monitor the service provider's compliance with the terms of any agreements and assess the service provider's continued fitness and ability to perform the covered activities being outsourced.

In addition, NtM 05-48 makes clear that, under certain circumstances, a function outsourced to a third-party service provider renders the person performing that function an associated person of the member by virtue of performing that function, thereby effectively negating any outsourcing because members are responsible for the supervision of all associated persons. NtM 05-48 also points out that the ultimate responsibility for supervision lies with the member. Accordingly, the member may never contract its supervisory and compliance activities away from its direct control,

although it may outsource certain activities that support the performance of its supervisory and compliance responsibilities.

The full text of the NASD Interpretive Letter can be viewed at the same site as Notice to Members 05-48 at http://www.nasd.com/RulesRegulation/NoticestoMembers/2005NoticestoMembers/NASDW_014736.

Internal Risk Management Control Systems of Consolidated Supervised Entities

In April 2004, the SEC adopted rule amendments under the Exchange Act that establish a voluntary, alternative method of computing deductions from net capital for certain broker-dealers that are part of a consolidated supervised entity (CSE). This alternative method permits a broker-dealer to use mathematical models to calculate net capital requirements for market and derivatives-related credit risk.

According to the amended rules (Appendixes E and G to Rule 15c3-1, "Net Capital Requirements for Brokers or Dealers"), broker-dealers that use this alternative method of computing net capital are required to have both their internal audit function and external auditors perform specific procedures related to their internal risk management controls in accordance with Rule 15c3-4, "Internal Risk Management Control Systems for OTC Derivatives Dealers," under the Exchange Act. The amended rules specify that only a *registered public accounting firm* (as that term is defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 *et seq*.)) could act in the capacity of an external auditor for such broker-dealers. Under the rule, the external auditors would be required to review the internal risk management control system in accordance with procedures agreed upon by the broker-dealer, the external auditor conducting the review, and the SEC.

The five industry participants currently registered as CSEs made a proposal to the SEC in late 2005 to replace the requirements for an annual accountants report on internal risk management control systems under Rule 15c3-1 Appendix G (b)(1)(iii)(B) with

an emphasis on the role the internal audit department (IAD) would play in reviewing such controls each year. IAD would provide appropriate feedback on the regular assessment, and operating effectiveness, of the internal risk management control system within CSE registrant firms covered by Rule 15c3-4 to both senior management and the audit committee. The SEC Division of Market Regulation has agreed to the proposal which is being implemented in 2006.

Review Requirements

The CSE registrants are required to demonstrate that the internal risk management control systems (as defined in Rule 15c3-4) are included within IAD's universe of coverage, that IAD reviews the key elements of those activities on a periodic basis, and that the results of those reviews are reported to senior management and the audit committee, and members of IAD are available for discussion with the SEC. In addition, IAD's periodic reviews must be conducted on a frequency and scope driven by a risk assessment program.

As part of the proposal, internal risk management control system reviews should be conducted by IAD at three levels:

1. *Risk Oversight and Governance.* This is generally executed through senior risk management oversight committees that establish overall risk management policies. These committees cover, for example, credit and market risks. IAD is to conduct periodic governance reviews that include, as relevant, examination of the constitution of charters, span of authority, reporting procedures, the breadth and appropriateness of committee membership, sufficiency of committee minutes or similar documentation, and the frequency of meetings.

2. *Functional Risk Management.* This is generally executed by independent dedicated risk management functions within each CSE and includes day-to-day risk management activities, such as limit setting and monitoring, and firmwide risk aggregation. These dedicated risk management functions have responsibility for managing risks arising out of

business activities, including market, credit, leverage, liquidity, legal, and operational risks. IAD is to conduct periodic reviews of these risk management functions including, as relevant, examining policies and procedures, reporting lines, limit administration, escalation procedures for limit breaches, data accuracy and completeness, data security controls, testing and authorization controls over models, processes to establish internal credit ratings, and other activities relevant to each CSE's functional risk management.

3. *Business Level Risk Management.* This is generally executed by individual business/product areas within each CSE and includes day-to-day risk management activities such as limit monitoring, the requests and approval process for limit adjustments, and the transmission of risk data to the functional risk management areas. IAD is to conduct periodic reviews of these risk management activities as a component of their business/product area audits.

Communication Requirements

The scope of IAD's reviews of the internal risk management control system that should be regularly presented to the audit committee and the SEC's Division of Market Regulation should include the risk oversight and governance and functional risk management levels described above.

Audit Committee Communications. Periodically, but not less than annually, each CSE's IAD is to present the following materials to their audit committee at a meeting where their registered public accounting firm (RPAF) is present:

1. A schedule detailing the status of the year's audit plan over the internal risk management control system, including projected delays, if applicable
2. The rationale for any deferrals or delays in coverage
3. A review of the results of such audits

The audit committee minutes need to reflect that the above topics were discussed, and should include any relevant matters raised by the RPAF. Prior to the audit committee meeting, the RPAF should have had the opportunity to review relevant reports and working papers to be in a position to discuss IAD's coverage and findings related to the internal risk management control system, and to respond to other appropriate questions.

Periodic Meetings Between IAD and the Division of Market Regulation. The following specific items should be provided to the SEC's Division of Market Regulation in addition to materials already being provided during the recurring quarterly meetings relating to IAD's reviews of the internal risk management control system:

Quarterly meeting following internal audit's annual planning process:

1. IAD's universe of auditable entities comprising coverage over the internal risk management control system
2. A schedule detailing actual audit coverage, of the universe listed in item 1 above, for the past two years and projected coverage for the current and following year

Each quarterly meeting:

1. A schedule detailing the status of the year's audit coverage of the internal risk management control system, including projected delays, if applicable
2. A review of the results of completed audits relating to the internal risk management control system
3. A schedule detailing any open and past due significant issues arising from the reviews of the internal risk management control system
4. Organizational chart showing internal audit's independent reporting lines, if applicable, due to any changes since the last meeting

At the request of the SEC's Division of Market Regulation, RPAFs may meet annually with the Division of Market Regulation, with the consent of the CSE's management, to discuss matters relevant to the CSE's IAD review of the internal risk management control system.

The requirements discussed above are included in chapter 6 of the 2006 edition of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*. The Broker Dealer Guide also includes two new appendixes related to CSE reporting, namely, Appendix L, "Auditor's Standard Report on Consolidated Supervised Entity," and Appendix M, "Separate Report on the Supplementary Schedule of Consolidated Supervised Entity."

Broker-Dealer Internal Audit/Compliance Priorities

On October 17, 2006, Mary Ann Gadziala, Associate Director of the SEC's Office of Compliance Inspections and Examinations, spoke at the 2006 Annual Conference of the Internal Auditors Division of the Securities Industry Association (SIA). She discussed the SEC's approach to evaluating the internal audit function and areas of focus of the SEC examination program.

Evaluation of Internal Audit Work

The SEC broker-dealer examination program has recently begun the implementation of a new process whereby SEC examiners may leverage off the high quality work of a firm's internal audit department (IAD) in conducting their own risk management examinations. This process is being employed only with respect to risk management examinations of broker-dealers and consolidated supervised entities at the current time because these examinations are very resource-intensive. However, she indicated that the practices and procedures that she discussed may be relevant to the development of an effective internal audit program at any firm, regardless of whether it may be subject to an SEC risk management examination. Since the scope of SEC examination, in which this new process is used, will be somewhat dependent on the SEC's evaluation of the firm's internal audit work, the SEC risk management examination process has changed to permit

on-site examination to begin with a review of the work of the firm's IAD. After evaluation of the internal audit work, SEC examiners will conduct an examination of market, credit, legal and compliance, operational, and liquidity risks of the firm. They will use an examination scope that may be limited or adjusted based on the firm's internal audit work. She indicated that in order to evaluate the quality and strength of the firm's internal audit function, some areas that may be reviewed by the SEC include the qualifications and expertise of audit management and staff, the adequacy of resources and systems, the independence and authority of the IAD, and the adequacy of audit coverage throughout the organization with a focus on risk management audits.

One of the first documents reviewed by the examination team is typically the internal audit charter or similar document that defines the purpose, authority, and responsibility of the internal audit function and is approved by the top levels of the firm, such as senior management and the audit committee. This document should be maintained and updated on a periodic basis and would generally include the following:

- The objectives and scope of the internal audit function;
- The IAD's role within the firm;
- The authority and access of the head of IAD to top levels of the firm, such as the audit committee and senior business executives;
- IAD's powers and responsibilities, which include full and direct access to all records and activities of the firm, as well as access to and the ability to communicate with any employee of the firm;
- The accountability of the head of IAD; and
- The terms and circumstances under which IAD may act in an advisory or consulting role.

The independence of IAD is also critical to the effectiveness and quality of their evaluation of the activities and operations of an organization. Effective implementation of the internal audit

function requires that IAD have adequate resources, including personnel and technology to complete the audit plan and auditing tasks effectively and in a timely manner. Auditors should have adequate experience in both auditing and an understanding of business operations of the firm where the auditor has audit responsibilities. SEC examination staff may review résumés or biographies of the internal audit staff, the firm's policies and procedures with respect to minimum qualifications, and auditors' educational level and professional experience. Training and continuing education are also assessed during the examinations.

SEC examiners will evaluate the "audit universe" and audit cycles set by IAD, which are all the areas of a firm that expose it to risk. Among the SEC examiners' primary concerns regarding a firm's audit universe are its completeness, risk rankings, and cycles as related to risks and controls.

An effective IAD generally has thorough and clear procedures with respect to the conduct of its audits. Effective audit procedures may (1) explain how the auditor conducts audits; (2) describe the required working papers necessary to support the audit; (3) contain guidelines for testing and sampling; (4) discuss supervision of the audit; and (5) describe reporting of audit findings and audit reports.

SEC examiners will consider the guidance of recently issued SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), in their evaluation. SAS No. 103, which applies to audits of nonpublic companies, requires an auditor to prepare audit documentation that is sufficiently detailed for an experienced auditor having no previous connection to the audit to understand the audit work performed, evidence obtained, and conclusions reached. SAS No. 103 also requires auditors to assemble audit documentation that is the "final engagement file" within 60 days of the report release date. It also provides guidance on what to document; states that oral explanations by themselves are insufficient to support audit work or conclusions although they may be used to clarify audit documentation; and specifies a minimum file retention period of five years.

The firm's meaningful corrective action in response to the audit is also a key element of the effectiveness of IAD's work. Therefore, appropriate dissemination of results and follow-up are essential.

The SEC examination team will determine whether audit procedures include an adequate system to monitor audit findings and their resolution.

SEC Examination Focus Areas

She also discussed some of the current areas of focus for the SEC examination program, including:

- *Supervision.* Written supervisory procedures should be complete and updated to keep pace with regulatory or business changes. They also need to be effectively implemented. Large, high-volume firms using manual monitoring processes may raise supervisory concerns. Branch office supervision is a growing challenge as the number of branch offices has escalated to about 170,000, and many offices are independent contractors or at remote locations, offering additional challenges. Outsourcing of more and more activities also raises supervisory issues. Supervising correspondence also remains a priority.

- *Sales Practices.* Sales and marketing to senior citizens is a top concern. SEC examiners are focusing on certain products with more frequent sales practice problems, including Section 529 plans, variable annuities, illiquid securities, and initial public offerings (IPOs). Instances of retail and corporate bond dealers charging large mark-ups or markdowns on riskless principal and inventory transactions may raise suitability concerns. Also, SEC examiners continue to find firms that are not providing investors with appropriate breakpoint discounts on mutual fund purchases.

- *Risk Management.* Firms continue to make significant advances in risk management internal controls. However, there are still some areas to which special attention might be directed. For example, it is a good practice for firms to continually monitor and update business continuity plans

as appropriate to implement technological advancements and address new challenges, such as a potential pandemic. Assuring that back office operations and compliance keep pace with sales and marketing new products is an area of focus. And SEC examiners are examining whether firms are effectively addressing problems with assignments and confirmations with respect to credit derivatives. Complex structured finance transactions should also be carefully monitored for appropriate risk management. Information security is a key risk management concern, particularly in view of increased instances of identity theft. Another critical risk management area is conflicts of interests, which should be carefully monitored especially by firms with diversified activities and customers.

- *Financial Issues.* Net capital deficiencies and inaccuracies in computing net capital remain among top findings from SEC examinations. Imposing adequate margin requirements on customers, particularly hedge funds and other significant or highly leveraged customers, is also an area of focus. Firms should be mindful of developments with respect to portfolio margining. SEC examiners have also focused a significant amount of attention on the alternative net capital computations of broker-dealers using methodologies that incorporate the concepts of the Basel capital requirements with internal mathematical models as the underlying basis.
- *Anti-Money Laundering (AML).* Some areas of focus are: firms' relationships with foreign institutions; general risk assessment and suspicious activity reporting; independent tests—are they timely, comprehensive, and conducted by a person with sufficient knowledge of AML laws; whether firm compliance programs are adequate and effectively implemented; and whether each regulated entity has met its independent obligations under the USA PATRIOT Act.
- *Books and Records.* Having accurate books and records is a key component of ensuring compliance with the law and having financial integrity and accuracy of financial

statements. They are also key to understanding firm operations and activities. It is important that all business-related correspondence and records, including e-mails, be accurately maintained and accessible as required.

- *Trading Practices.* Examinations continue to find instances of market timing in mutual funds, variable annuity products, and real estate investment trusts (REITs). Best execution of transactions is also an examination priority as well as compliance with Reg SHO. Trading practices is another area in which conflicts are a concern, particularly with respect to maintaining the confidentiality of nonpublic customer trade information and preventing insider trading, frontrunning, and market manipulation.

The full text of this speech is available at the SEC Web site at http://www.sec.gov/news/speech/2006/spch101706mag.htm.

Anti-Money Laundering Recent Regulatory Developments

Over the past several years, regulators have issued a number of rules to implement key provisions of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the USA PATRIOT Act). It is critical for securities firms to comply with AML regulations, as noncompliance may lead to serious negative consequences, including tarnished reputations, legal and regulatory problems, and, in some cases, civil or criminal actions. Also, laundered funds and their proceeds could be subject to asset seizure and forfeiture (claims) by law enforcement agencies, which could result in material contingent liabilities during the prosecution and adjudication of cases.

The following sections discuss recent AML developments as well as issues of continuing importance.

Customer Identification Programs

SEC No-Action Letter—Financial Recordkeeping and Reporting of Currency and Foreign Transactions/Broker-Dealer Customer Identification Rule. On July 11, 2006, the staff of the Division of

Market Regulation (Division), in consultation with the FinCEN, issued a letter stating that it would not recommend enforcement action to the SEC under Rule 17a-8 if a broker-dealer relies on an investment adviser, prior to such adviser becoming subject to an AML Rule, provided all the other requirements and conditions in paragraph (b)(6) of the CIP Rule are met, namely that (1) such reliance is reasonable under the circumstances; (2) the investment adviser is regulated by a federal functional regulator; and (3) the investment adviser enters into a contract requiring it to certify annually to the broker-dealer that it has implemented an AML program, and that it will perform (or its agent will perform) specified requirements of the broker-dealer's customer identification program. The relief will be withdrawn without further action on the earlier of (1) the date upon which an AML Rule for advisers becomes effective, or (2) January 12, 2008.

For more information please refer to http://www.sec.gov/divisions/marketreg/mr-noaction/antiml071106.htm.

Frequently Asked Questions Customer Identification Program Responsibilities under the Agency Lending Disclosure Initiative. In April 2006, FinCEN together with the SEC published guidance in the form of questions and answers that address customer identification program (CIP) responsibilities where a U.S. bank or broker-dealer (agent lender) arranges a loan of securities to a broker-dealer under the Agency Lending Disclosure Initiative. The question is whether a broker-dealer borrower is required to treat the agent lender's customers as "customers" for purposes of the CIP Rule. Under the circumstances described in the document, the answer is no. Notwithstanding the limited information the broker-dealer borrower obtains about the underlying lender(s), the "customer" of the broker-dealer for purposes of the CIP rule is the agent lender. This guidance can be viewed on the SEC Web site at http://www.sec.gov/divisions/marketreg/qa-cip.htm.

SIA AML Committee's Suggested Practices For Customer Identification Programs. In January of 2006, the SIA (now SIFMA) published *Suggested Practices For Customer Identification Programs* (CIP Suggested Practices), which is a supplement to the SIA's

Preliminary Guidance For Deterring Money Laundering Activity issued in 2002. The CIP Suggested Practices discusses the minimum identification information and verification procedures required by the CIP Rule and sets forth what the AML Committee believes are certain practices firms may wish to consider in developing and implementing an effective CIP. The CIP Suggested Practices can be found at http://www.sia.com/publications/pdf/CIPGuidelines.pdf.

Suspicious Activity Reports

FinCEN Guidance on Sharing of Suspicious Activity Reports by Securities Broker-Dealers, Futures Commission Merchants, and Introducing Brokers in Commodities. In January 2006, FinCEN, after consulting with staff of the SEC and CFTC, issued *Guidance on Sharing of Suspicious Activity Reports by Securities Broker-Dealers, Futures Commission Merchants, and Introducing Brokers in Commodities*, in which it confirms that securities broker-dealers, FCMs, and IBs in commodities may share Suspicious Activity Reports with parent entities, both domestic and foreign. For more information, please refer to FinCEN Web site at http://www.fincen.gov/sarsharingguidance01202006.pdf.

Foreign Correspondence and Private Banking Accounts

FinCEN Guidance on the Application of the Section 312 Rules to Certain Introduced Accounts and Give-up Arrangements in the Futures Industry. In June 2006, FinCEN issued guidance in the form of a letter to clarify the obligations of FCMs subject to the final due diligence rules implementing Section 312 of the USA Patriot Act. This guidance can be found at http://www.sia.com/moneyLaundering/pdf/FincenResptoBarbaraWierzynski.pdf.

FinCEN Guidance on the Application of the Section 312 Rules Requiring Special Due Diligence Programs for Certain Foreign Accounts. In May 2006, FinCEN issued guidance in the form of a letter to clarify the due diligence obligations for broker-dealers, FCMs, and IBs in commodities under the final rules of Section 312 of the USA Patriot Act. This guidance can be found at http://www.sia.com/moneyLaundering/pdf/SIA-FIAfrom FinCEN05-02-06.pdf.

AML Examination Findings

On March 29, 2006, Lori A. Richards, Director of the Office of Compliance Inspections and Examinations of the SEC, spoke at the Sixth Annual Anti-Money Laundering Conference hosted by the SIA, where she discussed some of the important issues that have come up in recent AML examinations. The full text of this speech is available on the SEC Web site at http://sec.gov/news/speech/spch032906lar.htm.

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

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

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

The Act establishes a deadline for registration with the PCAOB of auditors of financial statements of "issuers." The Act does not provide a deadline for registration of auditors of nonpublic broker-dealers.

On December 12, 2006, the SEC extended its Order permitting nonpublic broker-dealers (broker-dealers that are not "issuers") to file with the SEC a balance sheet and income statement and send to their customers a balance sheet certified by an independent

public accountant, instead of by a PCAOB registered public accounting firm for fiscal years ending before January 1, 2009.

The extension was originally issued on August 4, 2003, extended on July 14, 2004, and extended again on December 5, 2005. The 2005 Order was to expire on January 1, 2007. The SEC has determined that extending the Order for two additional years is consistent with the public interest and the protection of investors. See Release No. 34-54920 at http://www.sec.gov/rules/other/2006/34-54920.pdf for more information.

Application of registration requirements and procedures to auditors of nonpublic broker-dealers is still being considered.

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*, the 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.

The 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 could be used to record the 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 as to the amount of refund they should be setting aside for customers, which was to be based upon a sampling. Firms were either to record this amount or justify the appropriateness of selecting an alternative amount.

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.

The NASD believes that while firms have generally made substantive efforts to communicate the availability of restitution where it is warranted, the current absence of customers' claims does not on its own support removal of the liability.

Prior to reducing or removing its current liability, a firm should determine to the satisfaction of those responsible for the financial management of and reporting for the firm that such a reduction of the current balance of the breakpoint liability would be representationally faithful with respect to the firm's securities business and operating practices.

Further, in observing in the conduct of its business high standards of commercial honor and just and equitable principles of trade, a firm should continue to provide customers through its Web site ready-access to the NASD Mutual Fund Breakpoint Search Tool and related information found on NASD's Web site.

Finally, the firm should consider any customer claim regarding a possible failure to provide an available breakpoint discount, and as appropriate, compensate such customer upon determination of a bona fide claim, regardless of when the firm failed to provide an appropriate breakpoint discount.

Recent Concerns of Regulators

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

SEC

Consolidation of Subsidiaries. Regulators would like to remind broker-dealers and their auditors about the requirement of Rule 17a-5(d)(2), which provides that if the Statement of Financial Condition filed in accordance with instructions to Form X-17A-5, Part II or Part IIA, is not consolidated, a summary of financial data, including the assets, liabilities, and net worth or stockholders' equity for subsidiaries not consolidated in the Part II or Part IIA Statement of Financial Condition, as filed by the broker or dealer, should be included in the notes to the consolidated statement of financial condition reported on by the independent public accountant. Readers may also wish to refer to paragraphs 4.13 and 4.14 of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* for more information.

CFTC

Maintenance of Minimum Financial Requirements and Notification Requirements. CFTC Regulation 1.17 specifies minimum capital requirements and CFTC Regulation 1.12 specifies the conditions requiring FCMs to give notice of certain events occurring in a firm's financial or operational condition, changes or anticipated changes in capital balances, and how and when such notices are to be given.

For example, Regulation 1.12(g) requires that an FCM provide written notice of a substantial reduction in capital as compared to that last reported in a financial report filed with the CFTC pursuant to Regulation 1.10. If such reduction would be caused by a withdrawal of equity capital of 30 percent or more, notice must be provided at least two days prior to the withdrawal. For any reduction in net capital of 20 percent or more, notice must be provided within two days after the reduction.

FCMs should establish procedures to ensure that the notices required by CFTC regulations are filed with the CFTC within the established time frames set forth in the regulations. Particularly, it is a violation of CFTC rules for an FCM to file notice of a withdrawal of equity capital of 30 percent or more no earlier than two days prior to withdrawal. FCMs should not provide the notice

after the filing of the financial statements in which the withdrawal is reflected. Failure to make a timely filing negates the purpose of the rule, which is designed to alert the CFTC to a possible change in an FCM's financial condition. Notices should be filed promptly when due and provide an explanation for the decrease in net capital.

FCMs also should consider including details in the comments section of the electronically filed financial report affected by reporting when they have made or intend to make the filing required by Regulation 1.12(g).

Segregation of Customer Funds in Multiple Currencies. FCMs must maintain compliance with CFTC recordkeeping, computation, and segregation requirements applicable to customer funds held in multiple currencies. Regulation 1.20 requires that all customer funds be separately accounted for and segregated as belonging to commodity customers and deposited in an account that clearly identifies those funds as such. Regulation 1.32 requires each FCM to compute as of the close of each business day, on a currency-by-currency basis:

1. Total amount of customer funds on deposit in segregated accounts on behalf of commodity and commodity option customers;
2. Amount of such customer funds required to be on deposit in segregated accounts; and
3. Amount of the FCM's residual interest in such customer funds.

CFTC Regulation 1.49 specifies the conditions under which the FCM's obligations to a customer may be denominated in currencies other than the U.S. dollar. The regulation also specifies the geographic locations in which customer funds may be held, and the required qualifications for permissible depositories in those locations.

Some areas of recent focus in regard to these regulations include the treatment of customer-owned securities that are denominated in non-U.S. currencies, and which are held in depositories

outside of the U.S. All FCMs should take steps to ensure that such depositories satisfy all of the required criteria set forth in Regulation 1.49(d)(3). FCMs should also ensure that such customer owned securities are included in the segregation computation for the currency in which they are denominated.

Furthermore, FCMs should ensure that offsets to customer account deficits that are denominated in multiple currencies are computed in accordance with Rule 1.49(e). At the close of each business day, Rule 1.49(e) requires the FCM to maintain in segregated accounts sufficient U.S. dollars, held in the United States, to meet all U.S. dollar obligations, and also sufficient funds in each other currency to meet obligations in such currency, with certain permitted substitutions:

1. U.S. dollars held in the United States may be used to meet obligations denominated in any other currency, and
2. "Money center" currencies and U.S. dollars held in money center countries may be held to meet obligations denominated in currencies other than the U.S. dollar.

Regulatory Supplemental Schedules Required by CFTC. Within the last year, several FCMs have notified the CFTC that, as the result of errors in calculating the amount of funds that are held or required to be held in segregated accounts for customers, there have been overstatements of the amounts of excess funds in segregation versus those reported by the FCM in their annual audited financial reports filed with the CFTC. One of the reported errors affected the segregation statement and also caused this FCM to overstate its reported amount of excess net capital. FCMs should exercise appropriate diligence when preparing their regulatory schedules and have FCM supervisory personnel review the calculations before they are filed with the CFTC; FCMs should be aware that regulators are likely to subject these schedules to a higher level of scrutiny based on the errors mentioned above. FCMs may wish to consider CFTC guidance on materiality provided to Self-Regulatory Organizations (SROs) in CFTC Financial and Segregation Interpretation No. 4-1, which addresses SROs' responsibilities with respect to in-field examinations and

ongoing surveillance over members' compliance with the SRO/CFTC's financial, segregation, and related recordkeeping rules. FCM independent auditors may wish to read this guidance to assist them in evaluating the materiality of (1) errors affecting segregation or secured calculations, or (2) the impact these may have on an FCM's reported net capital/excess net capital. Attention is directed to paragraph 40 of this Interpretation, which defines a material error (for the purpose of an SRO in-field examination) as an error in any line item that would cause a change of 10 percent or more in excess net capital or excess segregated funds or where the adjustment, if made to the financial statements, would cause the FCM to fall below the "early warning" level. (Interpretation No. 4-1 can be accessed at the CFTC Web site at http://www.cftc.gov/tm/tmint4.htm).

SEC/CFTC

Reporting Material Differences between Unaudited and Audited Financial Statements. SEC Rule 17a-5 and CFTC Regulation 1.10(d)(2)(vi) require that if material differences exist between certain schedules that are filed in the registrant's audited and "most recent" unaudited FOCUS Report/Form 1-FR, a reconciliation, including appropriate explanations, must be included with the audited financial report filed with the SEC/CFTC. To avoid differences in the two reports, some registrants have filed subsequent amendments to the Form X-17-5/Form 1-FR routinely filed at the end of the year, incorporating into those filings, adjustments recommended by their independent auditors. Because of the amendments to the previous FOCUS Report/Form 1-FR, these firms claimed that there were no differences between the audited report and the firm's "most recent" FOCUS /Form 1-FR filing and would typically file no reconciliation. According to an SEC Letter to NYSE dated April 24, 1987 (the Letter), this interpretation frustrates the purpose of the Rule. The Rule requires that, in spite of the amendment, the audited version of the firm's year-end Form X-17A-5 contain a reconciliation and explanation of material differences, if any, as compared to the original filing at the end of the year. However, the Letter provides that if a broker-dealer files an amended FOCUS report that contains the

reconciliation and explanation of material differences between the amended report and the original report, the audited report may be reconciled with the amended FOCUS report and would include a statement as to whether any material differences are shown in the amendment. The CFTC's requirements are substantially the same.

Therefore, if the registrant's amended unaudited fiscal year-end report includes a reconciliation with appropriate explanations, no other reconciliation is required to be filed with the registrant's audited financial report, except where a separate reconciliation is necessary because there are material differences between the schedules filed in the audited report and the amended unaudited report. In such a case, the separate reconciliation filed with the audited financial report must specify that it has been made to the registrant's amended unaudited report.

NASD

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. Although 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—the broker-dealer presumably arranging for the provision of a service or product to a customer, independently of the customer—though, 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, 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. In view of market conditions and the increasingly competitive industry environment, broker-dealers continuously seek to develop and offer customers new investment services and products, such as the "cash sweep" account programs. Such programs transfer customer funds over time out of the broker-dealer to an interest-bearing account for the customer at a bank often affiliated with the broker-dealer. 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. Under the current market conditions, 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. 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*. Information Memo 05-11 provides that 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 (FDIC) 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. Information Memo 05-11 addresses issues involving the adoption of new cash sweep programs and provides procedures designed to safeguard investor interests for programs currently in place. It was prepared to set out best practices under current Exchange rules.

Currently, there is a joint industry effort to draft a circular that would request additional procedures related to bank-sweep programs. Among other things, it is expected that one of the provisions of the circular will be a requirement for broker-dealers to prepare a reconciliation between the broker-dealer's records and the amounts on deposit with each intermediary bank and destination bank. The circular is also expected to indicate that the auditors will need to include in the scope of their work procedures around this reconciliation prepared by the broker dealer, if applicable.

Appropriateness of Amounts Added Back to Owners' Equity in Computing Net Capital Related to Deferred Tax Liabilities. Certain firms believe that taxable temporary differences, such as deferred compensation and differences in the depreciation or amortization of non-financial assets, as well as nonsubstantive deferred tax 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 if the underlying asset is nonallowable, any related deferred tax liability should not result in a further reduction in deriving net capital.

In accordance with paragraph (c)(2)(i)(C) of the Securities Exchange Act Rule 15c3-1 (the Net Capital Rule), only deferred tax liabilities resulting from the recognition for financial statement purposes of unrealized income or appreciation related to long inventory, investment positions, or assets that are nonallowable for net capital can be added back to owners' equity in computing net capital. However, the SEC Division of Market Regulation staff has, by specific relief, permitted the add-back of deferred tax liabilities related to the capitalization of internally developed software and deferred advertising costs. The staff will consider requests for relief relative to specific transactions that result in the recognition in deferred tax liabilities which do not entail any associated recognition of unrealized income or appreciation for financial statement purposes.

SEC Regulations

The following is a summary of some 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—2006/07*, the AICPA *Independence and Ethics Alert—2006/07* (product no. 022477kk), and the AICPA *SEC and PCAOB Alert—2006/2007* (product no. 022497kk) 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.

- *Regulation NMS: Extension of Compliance Dates and Correcting Amendment.* In May 2006, the SEC extended the compliance dates for Rule 610 and Rule 611 of Regulation NMS under the Exchange Act. Rule 610 requires fair and nondiscriminatory access to quotations; establishes a limit on access fees; and requires each national securities

exchange and national securities association to adopt, maintain, and enforce written rules that prohibit their members from engaging in a pattern or practice of displaying quotations that lock or cross protected quotations. Rule 611 requires trading centers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the execution of trades at prices inferior to protected quotations displayed by other trading centers, subject to an applicable exception. The SEC extended the compliance dates to give automated trading centers additional time to finalize development of their new or modified trading systems, and to give the securities industry sufficient time to establish the necessary access to such trading systems. Dates: The effective date for Rule 610 and Rule 611 remains August 29, 2005. The initial compliance date for Rule 610 and Rule 611 has been extended from June 29, 2006, to a series of five dates, beginning on October 16, 2006, for different functional stages of compliance that are set forth in section II.A of this release. The effective date for this release is May 24, 2006. See Release No. 34-53829 for more information. Also, in December 2005, the SEC published a correcting amendment to Regulation NMS. See Release No. 34-51808A for more information.

- *Securities Offering Reform: Correction (technical amendments).* In February 2006, the SEC made technical corrections to rules adopted in Release No. 33-8591 (July 19, 2005), which were published in the Federal Register on August 3, 2005 (70 FR 44722). The adopted rules modify and advance significantly the registration, communications, and offering processes under the Securities Act of 1933. This document corrects certain errors in the regulatory text of the adopting release and otherwise clarifies certain of the rules. Effective date: February 13, 2006. See Release No. 33-8591A for more information.

Some other SEC rules that might be of interest primarily to those that are public companies:

- *Executive Compensation and Related Person Disclosure.* In August 2006, the SEC adopted amendments to the disclosure requirements for executive and director compensation, related person transactions, director independence and other corporate governance matters, and security ownership of officers and directors. These amendments apply to disclosure in proxy and information statements, periodic reports, current reports and other filings under the Exchange Act, and to registration statements under the Exchange Act and the Securities Act of 1933. The SEC also adopted a requirement that disclosure under the amended items generally be provided in plain English. Effective date: November 7, 2006. See Release No. 33-8732A for more information.
- *Amendments to Plan of Organization and Operation Effective During Emergency Conditions.* In June 2006, the SEC adopted amendments to certain of its rules that operate in the event of emergency conditions to revise the provisions on delivering submittals, the line of succession to the chairman in the event of the chairman's incapacity or unavailability, and make conforming changes. Effective date: June 9, 2006. See Release No. 34-53937 for more information.
- *Revisions to Accelerated Filer Definition and Accelerated Deadlines for Filing Periodic Reports.* In December 2005, the SEC adopted amendments to the accelerated filing deadlines that apply to periodic reports so that a "large accelerated filer" (an Exchange Act reporting company with a worldwide market value of outstanding voting and nonvoting common equity held by nonaffiliates of $700 million or more) will become subject to a 60-day Form 10-K annual report filing deadline, beginning with the annual report filed for its first fiscal year ending on or after December 15, 2006. Until then, large accelerated filers will remain subject to a 75-day annual report deadline. Accelerated filers will continue to file their Form 10-K annual reports under a 75-day deadline, with no further reduction

scheduled to occur under the revised rules. Accelerated filers and large accelerated filers will continue to file their Form 10-Q quarterly reports under a 40-day deadline, rather than the 35-day deadline that was scheduled to apply in 2006 under the previously existing rules. Further, the amendments revise the definition of the term *accelerated filer* to permit an accelerated filer that has voting and non-voting common equity held by nonaffiliates of less than $50 million to exit accelerated filer status at the end of the fiscal year in which its equity falls below $50 million and to file its annual report for that year and subsequent periodic reports on a nonaccelerated basis. Finally, the amendments permit a large accelerated filer that has voting and nonvoting common equity held by nonaffiliates of less than $500 million to exit large accelerated filer status at the end of the fiscal year in which its equity falls below $500 million and to file its annual report for that year and subsequent periodic reports as an accelerated filer, or a nonaccelerated filer, as appropriate. Effective date: December 27, 2005. See Release No. 33-8644 for more information.

- *Asset-Backed Securities; Technical Amendments.* In November 2005, the SEC issued corrections to final rules which were published in the Federal Register on Friday, January 7, 2005 (70 FR 1506). The rules relate to the registration, disclosure, and reporting requirements for asset-backed securities under the Securities Act of 1933 and the Exchange Act. Effective date: December 5, 2005. See Release No. 33-8518A 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 Concept Releases[3]

Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting. In July 2006, the SEC published this Concept Release to understand better the extent and nature of public interest in the development of additional guidance for management regarding its evaluation and assessment of internal control over financial reporting so that any guidance the SEC develops addresses the needs and concerns of public companies, consistent with the protection of investors. The comment period ended on September 18, 2006. See Release No. 34-54122 for more information.

SEC Interpretive Releases[4]

Commission Guidance Regarding Client Commission Practices Under Section 28(e) of the Securities Exchange Act of 1934. On July 18, 2006, the SEC published this interpretive release with respect to the scope of "brokerage and research services" and client commission arrangements under Section 28(e) of the Exchange Act. The SEC is soliciting further comment on client commission arrangements under Section 28(e). Section 28(e) of the Exchange Act establishes a safe harbor that allows money managers to use client funds to purchase "brokerage and research services" for their managed accounts under certain circumstances without breaching their fiduciary duties to clients. In this release, the SEC issued interpretive guidance with respect to the safe harbor, with the particular goal of clarifying the scope of "brokerage and research services" in the light of evolving technologies and industry practices. Effective Date: July 24, 2006. Market participants may continue to rely on the SEC's prior interpretations of Section 28(e) until January 24, 2007. Please see Release No. 34-54165 for more information.

3. The SEC occasionally publishes "concept" releases to solicit the public's views on securities issues so that it can better evaluate the need for future rulemaking. The SEC Concept Releases are available on the SEC Web site at www.sec.gov.

4. 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.

SEC Policy Statements[5]

Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities. On May 19, 2004, Office of the Comptroller of the Currency, Treasury (OCC); Office of Thrift Supervision, Treasury (OTS); Board of Governors of the Federal Reserve System (the Board); FDIC; and the SEC (collectively, the Agencies) issued and requested comment on a proposed Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities (Initial Statement) of national banks, state banks, bank holding companies, federal and state savings associations, savings and loan holding companies, U.S. branches and agencies of foreign banks, and SEC-registered broker-dealers and investment advisers (collectively, termed *financial institutions* or *institutions*). The Initial Statement described some of the internal controls and risk management procedures that may help financial institutions identify, manage, and address the heightened reputational and legal risks that may arise from certain complex structured finance transactions (CSFTs). After reviewing the comments received on the Initial Statement, the Agencies are requesting comment on a revised proposed interagency statement (Revised Statement). The Revised Statement has been modified in numerous respects to address issues and concerns raised by comments; clarify the purpose, scope, and effect of the Statement; and make the statement more principles-based. These changes include reorganizing and streamlining the document to reduce redundancies and focus the statement on those CSFTs that may pose heightened levels of legal or reputational risk to the relevant institution (referred to as *elevated risk CSFTs*). In addition, the Agencies have modified the examples of transactions that may present elevated risk to make these examples more risk-focused, and have recognized more explicitly that an institution's review and approval process for elevated risk CSFTs should be commensurate with and focus on the potential risks presented by the transaction to the institution. The Revised Statement will not affect or apply to the vast

5. From time to time, the SEC issues a policy statement to clarify its position on a particular matter.

majority of small financial institutions, nor does it create any private rights of action. Comment period ended on June 15, 2006. Please see Release No. 34-53773 for more information.

SEC Special Studies[6]

Economic Analysis of the Short Sale Price Restrictions Under the Regulation SHO Pilot. Short selling in exchange-listed stocks in the United States has been subject to a "tick test" and a "bid test" (the latter applies to NASDAQ National Market Stocks.) The tick test and bid test are generally referred to as *price restrictions*. In July 2004, the SEC adopted Regulation SHO, which contains Rule 202T, allowing the SEC to establish, by separate order, a pilot program to examine the efficacy of price restrictions. At the same time, the SEC issued an order (Pilot Order) establishing a pilot program (Pilot) exempting a third of the stocks in the Russell 3000 Index (Russell 3000) from all price restrictions. The Pilot went into effect on May 2, 2005, and was scheduled to end on April 28, 2006, but has been extended to August 6, 2007, to allow the SEC to consider potential rulemaking after evaluating the results of the Pilot. The Pilot was designed to enable the SEC and the broader community to evaluate whether the price restrictions have a substantive impact on market quality, and more generally to achieve a deeper understanding of how price restrictions affect the trading process. The goal of this study is to examine whether eliminating price restrictions has had any impact on market quality, broadly defined. In September 2006, the SEC issued a draft analysis as a result of this study.

The full text of this analysis can be found at http://www.sec.gov/about/economic/shopilot091506/draft_reg_sho_pilot_report.pdf.

Proposed Study to Compare Roles of Investment Advisers, Broker-Dealers. In August 2006, the SEC issued a request for contract proposals to conduct the first stage of a major study comparing how the different regulatory systems that apply to broker-dealers and investment advisers affect investors. The study was first

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

suggested in connection with a rule that the SEC adopted in April 2005. Broker-dealers are regulated under the Exchange Act. Investment advisers are regulated under the Investment Advisers Act of 1940. The 2005 rule allowed broker-dealers to offer fee-based brokerage accounts without being required to comply with the Advisers Act. The rule was the subject of a large number of comments. Many of the concerns that commenters raised in the rulemaking, however, went well beyond the circumstances covered by the rule; the investment professional study will help the SEC determine whether the concerns are justified and, if so, decide how best to respond.

The full text of the request for proposal can be accessed on the SEC's Web site at http://www.sec.gov/news/extra/2006/sechq1-06-r-0177.pdf. The SEC's rule providing for the study appears on the SEC's Web site at http://www.sec.gov/rules/final/34-51523.pdf.

Joint Report on Efforts of the Private Sector to Implement the Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System. Congress in the Intelligence Reform and Terrorism Prevention Act required the Federal Reserve, the Office of the Comptroller of the Currency, and the SEC (Agencies) to prepare a study on the efforts of the private sector to implement the Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System (Sound Practices Paper). As directed in the legislation, this report, which was released in April of 2006, discusses the efforts of private sector financial services firms covered by the Sound Practices Paper to implement enhanced business continuity plans, and the extent to which implementation has been done in a geographically dispersed manner. This report also addresses the agencies' views whether the Sound Practices Paper should be expanded to a larger range of private sector financial services firms that play significant roles in critical financial markets and whether legislative and regulatory changes are needed to expedite implementation by affected firms and optimize business continuity planning by the financial services industry.

The full text of the report can be found at http://www.sec.gov/news/press/studies/2006/soundpractices.pdf.

Other SEC Orders, Notices, Information

Order Granting Approval of Plan for Allocation of Regulatory Responsibilities Between The NASDAQ Stock Market LLC and the National Association of Securities Dealers, Inc. On July 12, 2006, the SEC approved and declared effective a plan for allocating regulatory responsibility between the NASDAQ Stock Market LLC (NASDAQ) and NASD. Accordingly, NASD will assume, in addition to the regulatory responsibility it has under the Exchange Act, the regulatory responsibilities allocated to it under the plan. At the same time, NASDAQ is relieved of those regulatory responsibilities allocated to NASD.

The plan is intended to reduce regulatory duplication for firms that are common members of NASDAQ and NASD. Included in the plan is an attachment that:

- Clearly delineates regulatory responsibilities with respect to specified NASDAQ rules and specified federal securities laws;
- Lists every NASDAQ rule that is identical or substantially similar to a NASD rule for which, under the plan, the NASD would bear responsibility for examining and enforcing compliance by common members;
- Includes the federal securities laws for which, under the plan, the NASD would bear responsibility for examining and enforcing compliance by common members;
- Provides that NASD shall not assume regulatory responsibility, and NASDAQ will retain full responsibility, for the surveillance and enforcement of trading activities or practices solely involving NASDAQ's own marketplace;
- Permits NASDAQ and NASD to terminate the plan for various reasons, including the nonpayment of fees, for cause, and for convenience.

Guide to Broker-Dealer Registration

In December 2005, the SEC Department of Market Regulation issued a Guide to Broker-Dealer Registration. The Exchange Act governs how the nation's securities markets and its brokers and dealers operate. The SEC prepared the guide to summarize some of the significant provisions of the Exchange Act and its rules. Firms will find information about whether they need to register as a broker-dealer and how they can register, as well as what standards of conduct and financial responsibility rules broker-dealers must follow. The guide covers a number of topics including:

- Who is required to register;
- How to register as a broker-dealer;
- Security futures;
- Conduct regulation of a broker-dealer; and
- Financial responsibility of a broker-dealer.

The guide is available at the SEC Web site at http://www.sec.gov/divisions/marketreg/bdguide.htm#I.

CFTC Regulations

The following summarizes certain amendments to regulations and interpretations of the CFTC) that became effective in the latter part of 2005 and in 2006. These amendments affected the financial reporting requirements of registered FCMs, and also of IBs that are not guaranteed by FCMs. They also included changes to the filing requirements of commodity pool operators (CPOs). The amendments were published in the Federal Register, and can be accessed electronically from the CFTC Web site at www.cftc.gov.

Alternative Capital Deductions for Market Risk and Credit Risk for FCMs Within "Consolidated Supervised Entities"

The CFTC issued final rules, effective February 2, 2006, that specify filing and other requirements that FCMs must comply with in order to elect to use certain alternative capital deductions for their proprietary trading assets instead of the capital

deductions that CFTC Regulation 1.17(c) would otherwise require. Only 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 based on internal mathematical models, may elect to use these same alternative deductions for the capital computations required by CFTC Regulation 1.17.

Simultaneously, rules were adopted affecting minimum net capital requirements of FCMs and IBs by reducing the capital deductions for their uncovered inventory or forward contracts in specified foreign currencies, consistent with prior CFTC staff guidance.

Revision of CFTC Financial and Segregation Interpretation 10

Effective February 13, 2006, Financial and Segregation Interpretation No. 10-1 was amended to prohibit FCMs from depositing, holding, or maintaining margin funds for customer accounts in third-party custodial accounts, except that, under certain specified conditions, FCMs may use such accounts for the assets of a customer that is a registered investment company (RIC) under the Investment Company Act of 1940, if the FCM is not eligible under SEC rules to hold such assets because it is an affiliate of the RIC or its adviser.

Requirement for Electronic Filing of Pool Financial Statements

Effective March 24, 2006, the CFTC amended its rules to require CPOs to submit commodity pool annual financial reports to the National Futures Association (NFA) via the NFA's electronic filing system. NFA implemented EasyFile, a Web-based system, for CPOs to file their annual financial reports electronically. The system was available in January 2005 for the December 31, 2004, annual report filings on a voluntary basis and became mandatorily effective March 24, 2006, in time for the filing of annual reports as of December 31, 2005. Detailed filing instructions are available on the NFA's home page, www.nfa.futures.org, under Electronic Filings, Easy File for Pool Filers. CPOs should not file hard copies of annual financial reports filed through EasyFile with either NFA or the CFTC. CPOs are required, however,

to provide hard copies of the annual reports to their pool participants, and maintain a manually signed copy of the audit report, readily available for inspection by regulators.

Increase in Minimum Capital Requirements

The CFTC posted on its Web site in July 2006 a revised Instructions Manual for the financial Form 1-FR-FCM, which noted necessary changes to FCM financial reports in order to reflect increased capital requirements adopted by NFA rule amendments that became effective July 31, 2006. These amendments, which were approved by the CFTC, increased minimum financial requirements for FCMs, IBs, and forex dealer members (FDMs), as follows:

- For FCMs, from $250,000 to $500,000;
- For IBs, from $30,000 to $45,000; and
- For FDMs, from $250,000 to $1,000,000.

The NFA amendments also imposed the following greater requirements:

- A $7,500,000 minimum capital requirement for FCMs with affiliates, if those affiliates are authorized to act as counterparties to off-exchange forex transactions with retail customers solely by virtue of their affiliation with a registered FCM; and
- A $5,000,000 minimum capital requirement for all FCMs that are counterparties to off-exchange forex options transactions with retail customers.

Also, effective November 30, 2005, the NFA adopted counterparty concentration charges for FDM foreign currency transactions as follows:

- For transactions with unregistered, unaffiliated counterparties, if the net open position with the counterparty exceeds 10 percent of the FDM's aggregate long or short position in a particular currency, the amount in excess of 10 percent is subject to a 6-percent haircut (if the currency

is euros, British pounds, Canadian dollars, Japanese yen, or Swiss francs) or a 20-percent haircut (for all other non-U.S. currencies).

- For transactions with affiliates, the required 6- or 20-percent haircut is applied 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.

CFTC Annual "Dear CPO" Letter

On February 17, 2006, 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:

- Due dates of commodity pool financial filings - late filings
- Amendments to Part 4
- Notification of a change in accountants
- Compliance with U.S. generally accepted accounting principles (GAAP)
- Requests for relief from U.S. GAAP compliance for certain offshore commodity pools
- Initial annual reports and final annual reports
- FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, implementation and its impact on participants' redemptions

- Reminder regarding availability of annual report information under the Freedom of Information Act (FOIA)

The letter also noted that the CFTC's Division of Clearing and Intermediary Oversight (DCIO) issued similar letters in prior years, available under the "Compliance Information" section of the CFTC's Web site at www.cftc.gov. Those letters should be consulted with respect to commodity pool annual financial statements and reporting. In addition, CFTC interpretations and staff letters providing guidance from 1995 forward are also available there. In particular, CFTC Interpretive Letter 94-3, *Special Allocations of Investment Partnership Equity*, addresses how a CPO should report such allocations to the general partner in a commodity pool's financial statements.

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, some of which are described in the following sections. Please refer to the Web sites of the respective SROs for a complete listing of recently issued rules and regulations.

Please note that on November 28, 2006, the NASD and the NYSE announced a plan to consolidate their member regulation operations into a SRO that will be the single regulator for all securities firms doing business with the public in the United States. Please refer to the NASD Web site at http://www.nasd.com/RegulatoryConsolidation/index.htm for more information.

NASD Rulemaking

- *Notice to Members 06-26—Amendments to Margin Rules to Reflect Additional Complex Option Spread Strategies.* On April 3, 2006, NASD filed with the SEC for immediate effectiveness a rule change to amend NASD Rules 2520 and 2522 that revised the margin requirements to recognize

specific additional complex option spread strategies for purposes of determining required margin, and has amended the provisions relating to "permitted offsets" for certain listed option transactions. Rules 2520 and 2522, as amended, are set forth in Attachment A of Notice 06-26. The effective date and the implementation date of the amendments was April 3, 2006.

- *Notice to Members 06-23—NASD Reminds FINOPs of their Obligations under NASD Rule 1022 and Issues Guidance to FINOPS Who Work Part-Time, Work Off-Site, or Hold Multiple Registrations.* NASD issued this *Notice to Members* to remind member firms and registered financial and operations principals (FINOPs) of a FINOP's duties and responsibilities under Rule 1022 (Categories of Principal Registration). These duties are applicable to all FINOPs, regardless of whether they are employed full-time or part-time, perform such duties on-site or off-site of the member firm or hold registrations with more than one firm. This Notice also provides additional guidance to assist FINOPs who are employed part-time, operate off-site, or hold multiple registrations in fulfilling their duties. Additionally, NASD reminds members and FINOPs that their failure to meet their responsibilities can result in disciplinary actions against both the FINOP and the member firm employing the FINOP.

- *Notice to Members 06-07—SEC Approves Amendments to Anti-Money Laundering Compliance Program Rule and Adoption of Interpretive Material.* On December 28, 2005, the SEC approved amendments to NASD Rule 3011 and the adoption of IM-3011-1 and IM-3011-2. The amendments and new interpretive material require a firm to conduct an independent test of its AML compliance program on an annual basis (with the exception of certain types of firms), clarify the persons not considered to be independent for purposes of the independent testing requirement, and require a firm, on a quarterly basis, to review and, if necessary, update the information regarding the firm's

AML compliance person. The new rule text and interpretive material are contained in Attachment A to Notice 06-07. The amendments became effective on March 6, 2006. Also see the "AML Testing Requirements and Auditor Independence" section of this Alert for a discussion of this rule amendment as well as the impact of AML testing engagements on the independence of auditors.

- *Notice to Members 06-04—SEC Approves Amendments to NASD Rule 3012 to Require Members Relying on Rule 3012's "Limited Size and Resources" Exception to Notify NASD of their Reliance.* On November 18, 2005, the SEC approved amendments to NASD Rule 3012 to require members relying on the "limited size and resources" exception to Rule 3012's general supervisory requirement for conducting producing managers' supervisory reviews to report electronically to NASD their reliance on the exception. NASD issued this *Notice to Members* to advise members of the rule change and to introduce the electronic reporting system that members will need to use to notify NASD of their reliance on Rule 3012's "limited size and resources" exception. Questions and answers relating to the rule change and the reporting system are included. The new rule text appears in Attachment A to Notice 06-04. It became effective on February 14, 2006. A sample screen shot of the electronic notification system Web page is in Attachment B to Notice 06-04.

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 06-86, Amendments to NYSE Rules 431 and 726 That Expand Customer Portfolio Margining.* See the "Portfolio Margining" section of this Alert.
- *Information Memo 06-57, Amendments to Rules 431 and 726 That Expand the Scope of Eligible Products for the Customer Portfolio Margining Pilot.* See the "Portfolio Margining" section of this Alert.
- *Information Memo 06-56, Amendments to Rules 104 and 123E to Change the Capital Requirements for Specialist Organizations.* On July 25, 2006, the SEC issued an order approving amendments to NYSE Rules 104, *Dealings by Specialists*, and 123E, *Specialist Combination Review Policy*, which change the capital requirements of specialist organizations. The amendments to Rules 104 and 123E restructure the capital requirements of specialist organizations from an approach based on the valuation of classes of allocated securities, which included capital penalties for mergers among specialists, to an approach based on specialist

market share measured by total dollar volume traded combined with market stress and volatility risk analysis.

- *Information Memo 06-51, Independent Contractor Arrangements.* The SEC approved amendments to the Interpretation of NYSE Rule 345, *Employees—Registration, Approval, Records*, that eliminate the requirement that proposed independent contractor arrangements be submitted to the NYSE for approval. Further, the amendments eliminate the general prohibition against the assertion of independent contractor status by persons who have been delegated supervisory responsibility pursuant to Rule 342, *Supervision—Approval, Supervision and Control.* The revised Interpretation appears in Exhibit A to Information Memo 06-51. It became effective immediately.
- *Information Memo 06-30, Guidance Pertaining to Business Continuity and Contingency Plans Relating to a Potential Pandemic.* The spread of avian flu that was experienced in 2006 raised concerns among governmental and public health officials of a near-term pandemic flu. A pandemic flu would involve the person-to-person transmission of a "virulent human flu that causes a global outbreak, or pandemic, of serious illness." Although there is no pandemic flu at this time, were one to occur, it could cause a significant and extended business interruption differing materially from the emergencies recently confronted by member organizations of the NYSE. For example, a pandemic flu is expected to occur in multiple "waves," each potentially spanning weeks or longer, and thus might have a substantially greater duration than the blackout of August 14 and 15, 2003, or the terrorist attacks of September 11, 2001. In addition, a pandemic flu is expected to involve outbreaks in numerous domestic and international locations. Therefore, unlike the regional emergencies created by Hurricanes Katrina and Rita, a pandemic flu might affect a member organization's main office, branch offices, backup locations, suppliers, and customers, regardless of their geographic diversity. As a result of the concern over a potential

pandemic flu, NYSE Regulation, Inc., issued this Information Memo to provide guidance to member organizations as to how to assess whether their Business Continuity and Contingency Plans (BCPs) would be suitable for a prolonged, widespread public health emergency. This memorandum reflects the current state of publicly available information concerning a potential pandemic and commonly accepted strategies for pandemic preparedness. Ultimately, the key to any BCP is flexibility: member organizations should tailor their planning efforts to their particular business models and customer needs, and should become and remain informed about developing pandemic flu projections.

- *Information Memo 06-22, Executive Responsibilities.* This Information Memo reminds member organizations that the front page of the FOCUS report specifically requires a distinct affirmation by the member organization, through its signatories, that the content of the FOCUS is "true, correct and complete." Consequently, in order to achieve the level of diligence necessary for this assertion, the chief financial officer (and other persons signing the Form) must be in a position to vouch for its content, based upon his or her knowledge of the information contained therein and the information supporting the filing. Persons signing the FOCUS report must be knowledgeable and have an independent basis for believing that the report is accurate and complete. The fact that certain clerical or computational activity has been outsourced will not serve to avert responsibility for the integrity of the final product. A close review of the report, questioning of those who may have prepared elements of it and inquiry into specific items on a random basis may be insufficient if the report is later determined to be inaccurate or incomplete; ultimate responsibility cannot be delegated. Member organizations should have systems in place to ensure that processes for the reconciliation, posting, and preparation of books and records are performed accurately and on a timely basis. The levels of care and application called for in the preparation of the

FOCUS report are also applicable to forms and filings that are submitted by the member organization to all regulatory authorities, and conscientious diligence must be a uniform standard. Member organizations and their principal executives are urged to review their practices and procedures to ensure that the content of each FOCUS report and other financial submissions to the Exchange satisfy the level of accuracy required.

- *Information Memo 06-21*, Revised: *Agency Lending Disclosure Initiative*—Revised Timeline. Information Memo 06-21 is an update to Information Memo 05-39, *Agency Lending Disclosure Initiative*, which was issued in June 2005. 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 few 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: (1) maintain books and records of loan activity with each underlying principal lender, (2) monitor credit exposure to each underlying principal lender, and (3) 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 (the 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. 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 (ALDI) can be found on its Web site at www.agencylending.capco.com. As an update to Information Memo 05-39, the ALDI Industry Taskforce revised the milestones on the specific timeline for the ALDI and those revisions are reflected in Information Memo 06-21. October 1, 2006 was the deadline for completion of ALDI.

- *Information Memo 06-04, Amendments to Rule 445, Anti-Money Laundering Compliance Program.* On January 25, 2006, the SEC issued an order approving amendments to NYSE Rule 445, *Anti-Money Laundering Compliance Program.* Rule 445 requires NYSE members and member organizations to develop an AML compliance program designed to comply with the requirements of the Bank Secrecy Act and the implementing regulations promulgated thereunder. Rule 445 further requires the designation of a person or persons, commonly known as *AML Officers*, responsible for implementing and monitoring the AML program's day-to-day operations and internal controls. In addition, Rule 445 requires the "independent testing" of the AML program. The amendments to Rule 445 (which appear in Exhibit A to Information Memo 06-04) establish a time frame for the "independent testing" requirement, a standard to determine who is adequately qualified and sufficiently independent to conduct such testing, and affiliation guidelines for AML Officers (which appear in Exhibits B and C to Information Memo 06-04). The amendments became effective immediately. Also see the "AML Testing Requirements and Auditor Independence" section of this Alert for a discussion of these amendments as well as the impact of AML testing engagements on the independence of auditors.

- *Information Memo 05-108, Elimination of Paper Copy FOCUS Report Submission to NYSE.* Effective with the January 2006 filing of Form X-17A-5 FOCUS Report, the electronic submission of the FOCUS Report has been the only filing required to meet the reporting requirement of SEA Rule 17a-5, *Reports to Be Made by Certain Brokers and Dealers.* Consequently, members and member organizations are no longer required to submit a paper copy of the FOCUS Report to the NYSE. Members and member organizations are reminded that the signatures of at least two principal executive officers or partners are required on the cover page of the FOCUS Report at the time it is electronically filed with the Exchange. Specialist organizations that deduct specialist haircut charges pursuant to SEA Rule 15c3-1(c)(2)(vi) but also add back haircut charges to their capital on their specialist positions pursuant to SEA Rule 15c3-1(c)(2)(vi)(N), and where this add-back to capital is only disclosed on their paper copy FOCUS Reports, should continue to retain these FOCUS Reports as part of their books and records pursuant to SEA Rule 17a-4, Records to be Preserved by Certain Exchange Members, Brokers and Dealers, and NYSE Rule 440, Books and Records. NYSE staff may request to review these FOCUS reports during their examinations.

- *Information Memo 05-101, Amendments to NYSE Rule 342.30—Annual Report; Chief Compliance Officer Designation; Chief Executive Officer Certification.* On November 16, 2005, the SEC approved amendments to NYSE Rule 342, *Offices—Approval, Supervision and Control*, and its Interpretation that require each member not associated with a member organization (non-associated member) and each member organization to file with the Exchange, by April 1 of each year, a report (the Annual Report) that addresses the member's or member organization's supervision and compliance efforts during the preceding calendar year, as well as ongoing compliance processes and procedures. The Amendments also require that each member organization's Annual Report include the designation of a principal

executive officer or general partner as chief compliance officer. The Amendments further require that the Annual Report include a certification, signed by the non-associated member or the Chief Executive Officer of the member organization submitting it, that processes are in place to establish, maintain, and review policies and procedures reasonably designed to achieve compliance with applicable Exchange rules and federal securities laws and regulations (a sample Certification Form is included as Exhibit C). The amendments became effective immediately; the annual report for calendar year 2005 was due April 1, 2006.

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

Audit and Accounting Issues and Developments

Trends in SEC Comment Letters

Income Statement

SEC Regulation S-X, Article 5-03 provides guidance on income statement presentation, which is geared towards commercial and industrial companies. The AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* and the AICPA Practice Aid, *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools,*[7] provide a different format for income statement presentation. Recently, the SEC has requested several financial service filers to change their income statement format to comply with that of Article 5-03. In some of those cases, the SEC has accepted expanded disclosure in lieu of changing the presentation of the income statement.

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

Statement of Cash Flows

In the past year, there have been a number of restatements in the area of cash flow statements. In the financial services industry, most of the restatements were due to incorrect application of guidance in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Acquired for Resale.* Paragraph 9 of FASB Statement No. 102 states:

> Some loans are similar to securities in a trading account in that they are originated or purchased specifically for resale and are held for short periods of time. Cash receipts and cash payments resulting from acquisitions and sales of loans also shall be classified as operating cash flows if those loans are acquired specifically for resale and are carried at market value or at the lower of cost or market value. Cash receipts resulting from sales of loans that were not specifically acquired for resale shall be classified as investing cash inflows. That is, if loans were acquired as investments, cash receipts from sales of those loans shall be classified as investing cash inflows regardless of a change in the purpose for holding those loans.

A number of finance companies had restatements resulting from the misclassification of cash flows related to certain loans that were originated or purchased with the intent to sell as cash flows from investing activities, instead of operating activities, which is the presentation required by FASB Statement No. 102.

Issues associated with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*

Numerous companies have been required to restate their financial statements due to technical noncompliance with the provisions of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, although their derivatives performed as expected as effective economic hedges. Broker-dealers applying hedge accounting pursuant to FASB Statement No. 133 should ensure that their application of hedge accounting is contemporaneously documented and meets all requirements of FASB Statement No. 133 and related implementation guidance.

In particular, firms applying the "shortcut" method of hedge accounting should ensure that their application is appropriate and consistent with paragraph 68 in its entirety and that any unique features of instruments are evaluated closely in consideration of paragraph 68e. FASB Statement No. 133 limits the use of the "shortcut" method to hedges of interest rate risk that involve interest-rate swaps and recognized interest-bearing assets or liabilities. It also requires that general hedge requirements such as contemporaneous formal documentation be met. It then adds nine additional criteria, specific to shortcut method hedges, which must also be met. Furthermore, Derivative Implementation Group (DIG) Issue E4, *Hedging-General: Application of the Shortcut Method*, indicates that each and every one of the shortcut criteria must be met and that "a hedging relationship cannot qualify for application of the shortcut method based on an assumption of no ineffectiveness justified by applying other criteria."

AML Testing Requirements and Auditor Independence

NASD Rule 3011 and NYSE Rule 445, both entitled *Anti-Money Laundering Compliance Program*, require, among other things, that member firms and member organizations independently test their AML programs. In *Notice to Members 02-21*, NASD stated that such testing can be done by either personnel of the broker-dealer or a qualified outside party. In one of the speeches by SEC staff, the following was said in connection with this requirement: "Many of you have voiced concerns regarding this requirement. As regulators, we understand that maintaining the independence of auditors can be a challenging task for small firms." As a result, many practitioners have questioned whether the auditor's independence is compromised if the auditor performs the independent AML testing for a firm that is an audit client.

The 2006 conforming changes to the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* include revisions to the "Anti-Money Laundering Regulations" section to address this concern. Specifically, based on discussions with SEC staff, paragraph 3.103 was revised to indicate that,

> It would be proper for the auditor of the broker-dealer to perform testing of anti money laundering program if it is done in accordance with attestation standards. It can be performed as agreed upon procedures, or an attestation of management assertions. However, if performed as a consulting service, such as generating work papers, reports for the NASD or NYSE to review, the SEC staff believes this would be considered a management function, and therefore, would impair the auditor's independence.

It should be noted that both NASD and NYSE recently amended their AML testing requirements. On December 28, 2005, the SEC approved amendments to NASD Rule 3011 and the adoption of new interpretive material IM-3011-1 and IM-3011-2. The amendments and new interpretive material clarify that, in most instances, firms are required to test their AML programs at least annually (on a calendar-year basis). However, the rule change allows firms that do not execute transactions for customers or otherwise hold customer accounts and do not act as an introducing broker with respect to customer accounts, to test once every two years (on a calendar-year basis) rather than on an annual basis. The amendments and new interpretive material also clarify the persons not considered to be independent for purposes of the independent testing requirement and require a firm, on a quarterly basis, to review and, if necessary, update the information regarding the firm's AML compliance person. For more information please refer to NASD Notice to Members 06-07, which is discussed in the "NASD Rulemaking" section of this Alert.

On January 25, 2006, the SEC approved amendments to NYSE Rule 445. The amendments to Rule 445(3) establish that members and member organizations that conduct a public business must independently test their AML program, at a minimum, on an annual calendar year basis. Members and member organizations that do not conduct a public business must independently test their AML Program, at a minimum, every two calendar years. Members and member organizations that conduct no public business include those that engage solely in proprietary trading or that conduct business only with other broker-dealers. Section .10

of the Rule's Supplemental Material obliges members and member organizations to undertake more frequent testing if circumstances warrant (for example, a material change to the business mix of the member or member organization; in the event of a merger or acquisition; if testing of the AML program reveals systematic weaknesses; or in response to any other regulatory red flags). The amendments to rule 445 also establish a standard to determine who is adequately qualified and sufficiently independent to conduct such test, and establish affiliation guidelines for AML officers. For more information, please refer to NYSE Information Memo 06-04, which is discussed in the "NYSE Rulemaking" section of this Alert.

Annual Certification of Compliance and Supervisory Processes

NASD Rule 3013, *Annual Certification of Compliance and Supervisory Processes*, requires members to (1) designate a chief compliance officer (CCO) and (2) have the chief executive officer (CEO) or equivalent officer certify annually that the member has in place processes to establish, maintain, review, test, and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable NASD rules, Municipal Securities Rulemaking Board (MSRB) rules, and federal securities laws and regulations. Recently amended NYSE Rule 342.30, *Annual Report and Certification*, contains similar requirements. (For more information on the NYSE rule, please refer to NYSE Information Memo 05-101, which is discussed in the "NYSE Rulemaking" section of this Alert.) First annual certification pursuant to these rules had to be executed by April 1, 2006.

Given that 2006 is the first year in which these certifications are to be executed, auditors should consider obtaining and reading this letter to ensure there are no compliance issues affecting the internal control and/or financial reporting of their broker-dealer clients.

Report on Internal Control

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

For audits of financial statements for periods ending before December 15, 2006, auditors may follow guidance in AICPA Statement on Auditing Standard (SAS) No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU section 325), to satisfy the internal control reporting requirements described above. SAS No. 60 defines a material weakness in internal control as a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

In May 2006, the ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, which supersedes SAS No. 60 (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 112 is effective for audits of financial statements for periods ending on or after December 15, 2006. Earlier implementation is permitted. Auditors who audit financial statements for periods ending on or after December 15, 2006, or choose to implement SAS No. 112 early, should follow guidance in SAS No. 112 when reporting on internal control of their broker-dealer clients.

SAS No. 112 provides the following definitions:

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

- A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

Among other matters, SAS No. 112 also:

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

Paragraph 3.85 of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* 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 3.91 and 5.100 through 5.103 of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* for additional guidance on broker-dealer internal control reporting. The guide also provides examples of reports on internal control in Appendixes C, "Report on Internal Control Required by SEC Rule 17a-5;" D, "Report on Internal Control Required by SEC Rule 17a-5 for a Broker-Dealer Claiming an Exemption From SEC Rule 15c3-3;" and F, "Report on Internal Control

Required by CFTC Regulation 1.16 and SEC Rule 17a-5(g)(1)." Please note that the 2006 edition of the guide contains two versions of each appendix, one based on guidance in SAS No. 60 (Appendixes C, D, and F) and the second version is based on guidance in SAS No. 112 (Appendixes C-1, D-1, and F-1). Similarly, chapters 3 and 5 of the guide contain guidance based on both SAS No. 60 (paragraphs 3.81 and 5.100) and SAS No. 112 (paragraphs 3.82-3.84 and 5.101-5.103).

Following the issuance of PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, AU sec. 320),[8] in June of 2004, 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 have performed additional procedures to be able to report on the consolidated entity's financial statements and internal control in accordance with PCAOB standards. As auditors performed more internal control work for such broker-dealer clients, they became aware of additional issues and areas in which problems may arise, which could also explain the increase in the number of reported material weaknesses and material inadequacies.

The number of material weaknesses and material inadequacies reported to the regulators is expected to increase even further as auditors start adopting SAS No. 112.

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

8. On December 19, 2006, the PCAOB issued a proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements,* which would supersede PCAOB Auditing Standard No. 2. For more information, please refer to the discussion in the *"Auditing Pipeline—Public Companies"* section of this Alert.

Standard No. 2 and SAS No. 112, 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 also 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 whether there is a material weakness or material inadequacy.

Also, auditors who assist their broker-dealers clients with drafting financial statements have questioned whether this constitutes a significant deficiency or a material weakness. The answer is that it depends and there is nothing that the auditor does or does not do that creates an automatic deficiency. The client's internal control system, which should encompass the preparation of the financial statements, is independent of the auditor's work and vice versa. The auditor cannot be part of the client's internal control system, because to become part of the client's system would impair independence. If the auditor is involved in assisting the client with drafting financial statements (or anything else that is directly or indirectly related to the financial statements) the auditor needs to assess whether the client's controls are designed and placed in operation to prevent and detect a material misstatement to the financial statements.

Auditors may find it helpful to refer to the new Audit Risk Alert entitled *Understanding SAS No. 112 and Evaluating Control Deficiencies—A Companion to SAS No. 112* (product no. 022536kk). This Audit Risk Alert provides an overview of the requirements of SAS No. 112 and how this SAS differs from SAS No. 60. Plus, this Risk Alert offers several case studies that highlight a particular control deficiency. Each case study contains a description of

the control deficiencies, and an analysis of the assessment of the severity of the control deficiency to help readers better understand and evaluate control deficiencies.

Brady Bond Warrants

For many years, warrants tied to the price of oil and issued with dollar denominated foreign bonds (Brady Bonds) were considered worthless and written off, given the low value of the price of oil. As a result, securities firms were not diligent in their clearance and settlement of the warrants as they were with the bond with which it traded.

However, with the escalation of the price of a barrel of oil, these instruments have significant value. Now, firms are undertaking substantial efforts to review their books and records, identify those counterparties that failed to deliver the warrants as well as those counterparties that failed to receive warrants, and enter into arrangements to settle outstanding obligations.

As an auditor of a broker-dealer, you need to be satisfied concerning the propriety of any financial statement asset or liability related to the failure to receive or deliver a Brady Bond Warrant and the appropriateness of its consideration for Net Capital and Customer Reserve Formula computation purposes.

Demutualization of Exchanges

Background

Demutualization is the process through which a member-owned organization becomes shareholder-owned. This frequently occurs as part of taking an organization public. Over the past several years, a number of stock and commodity exchanges underwent demutualization, and some are considering it.

In 2000, the Chicago Mercantile Exchange (CME) became the first U.S. financial exchange to demutualize into a shareholder-owned corporation. It went public in December of 2002, becoming yet again the first exchange to do so. The Chicago Board of Trade (CBOT) became public in October 2005. (The CBOT has agreed to merge with the CME.) In March 2006, the NYSE

became a for-profit, publicly traded company following the completion of its merger with an electronic stock-exchange operator, Archipelago Holdings Inc. In November 2006, the parent of the New York Mercantile Exchange (NYMEX), NYMEX Holdings, Inc. went public with an IPO.

As part of these transactions, seat owners typically receive shares in the successor company, a cash payment, or a mixture of both. The received shares often have transfer restrictions. For example, shares of NYSE Group, Inc. (NYX), the combined firm formed as a result of the merger between the NYSE and Archipelago Holdings Inc, are subject to transfer restrictions for three years with one-third of the restriction lifted every year. After restrictions on the NYX stock expire, there is no requirement for broker-dealers to own any stock in the Exchange in order to trade directly on the Exchange; however, broker-dealers will have to buy annual trading licenses. Other exchanges have different terms and require broker-dealers to own a certain number of shares in the exchange in order to conduct business there.

There are a number of accounting issues associated with demutualization of financial exchanges, some of which are discussed below.

Shares With Transfer Restrictions

An ownership interest in an exchange that is not required to be held for operating purposes and is a financial instrument should be accounted for at fair value. On September 15, 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, which provides enhanced guidance for using fair value to measure assets and liabilities. FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year.

FASB Statement No. 157 clarifies that the exchange price is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the

reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the definition focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price). FASB Statement No. 157 clarifies that market participant assumptions also include assumptions about the effect of a restriction on the sale or use of an asset. It provides that a fair value measurement for a restricted asset should consider the effect of the restriction if market participants would consider the effect of the restriction in pricing the asset.

However, even prior to the issuance of FASB Statement No. 157, the predominant practice was to factor in the restriction period in the fair value of the restricted stock through some discount of the market price for those securities that are freely traded. Most firms would mark these positions to market through the income statement, but would reduce the value by some percentage based on the restriction period. Each firm is expected to use judgment to estimate the discount percentage due to the restriction. Typically, sale restrictions would be evaluated by period. For example, securities saleable in one year might be discounted by 10 percent, those saleable in two years, by 15 percent, and those saleable in three years, by 20 percent. These percentages are for illustrative purposes only and will vary depending on the facts and circumstances. In practice, the percentages typically range between 5 percent and 30 percent.

NYSE Interpretation Memo 06-03 discusses the net capital treatment of NYX shares of common stock and provides that the NYX shares subject to transfer restrictions should be treated as a nonallowable asset for net capital purposes in accordance with SEC Rule 15c3-1(c)(2)(vii) for the duration of the applicable restriction period. The net capital treatment of nonrestricted NYX shares will be the same as that of any other nonrestricted security,

as outlined in SEC Rule 15c3-1(c)(2)(vi). The Memo also reminds noncarrying member organizations that a PAIB agreement is required for any nonrestricted NYX shares held by their carrying organizations in order for the shares to be deemed an allowable asset for net capital purposes.

Shares Required to be Owned in Order to Conduct Business on an Exchange

Some exchanges, including the CME and CBOT, require broker-dealers to own a certain number of shares in order to trade on the exchange, or to obtain the lower "member" rates. These shares may represent either (*a*) both an ownership interest and the right to conduct business on the exchange, or (*b*) an ownership interest, which must be held by a broker-dealer to conduct business on the exchange. These shares should be accounted for at cost or at a lesser amount if there is an other-than-temporary impairment in value as provided in paragraph 7.34 (a) of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*.

Annual Trading License

In order to be able to trade directly on the NYSE, broker-dealers have to buy one-year trading licenses. The cost of the license should be set up as prepaid asset (nonallowable for net capital purposes) and amortized to expense monthly.

AICPA 2006 Audit and Accounting Guide *Brokers and Dealers in Securities*

AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, with conforming changes as of May 1, 2006 (product no. 012706kk), 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 Broker Dealer 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 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*, (available at http://www.aicpa.org/Magazines+and+Newsletters/) and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA's Auditing Standards team (available at http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion/.)

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 http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/. 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.

SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standard* SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (December 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	These standards established two categories of professional requirements that are identified by specific terms. The words *must* or *is required* are used to indicate an unconditional requirement. The word *should* is used to indicate a presumptively mandatory requirement. (The words *may*, *might*, *could*, and *should consider* represent actions that auditors have a professional obligation to consider.) The provisions of SAS No. 102 and SSAE No. 13 were effective upon issuance. It is the ASB's intention to make conforming changes to AICPA literature over the next several years to remove any language that would imply a professional requirement where none exists.
SAS No. 103, *Audit Documentation* (December 2005) (Not applicable to audits conducted in accordance with PCAOB standards)	See the "Statement on Auditing Standards No. 103" section below.
SAS No. 104-111, Risk Assessment Standards	See the "AICPA Risk Assessment Standards" section below.
SAS No. 112, *Communication of Internal Control Related Matters Identified in an Audit* (May 2006) (Not applicable to audits conducted in accordance with PCAOB standards)	This new standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), as amended. It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. Effective for periods ending on or after December 15, 2006. See the "Report on Internal Control" section above which also discussed major provisions of SAS No. 112.

(continued)

SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (December 2006) (Not applicable to audits conducted in accordance with PCAOB standards)	See the "Statement on Auditing Standards No. 114" section below.
Non-Authoritative Practice Aid, *Alternative Investments—Audit Considerations*	See the "AICPA Practice Aid *Alternative Investments—Audit Considerations*" section below.
PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* (February 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	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 to AT 101.04, *Attest Engagements* (February 2006) (Applicable to audits conducted in accordance with PCAOB standards only)	*Conforming Amendment to PCAOB Related Auditing and Professional Practice Standards Resulting from the Adoption of The Auditing Standard No. 4* This states that Auditing Standard No. 4 must be used for reporting on whether a material weakness continues to exist for any purpose other than a company's internal use.

AICPA Risk Assessment Standards

In March 2006, the AICPA ASB issued eight SASs that provide extensive guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit. The following table lists the eight SASs and their effect on existing standards:

Statement on Auditing Standard	*Effect on Existing Standards*
SAS No. 104, *Amendment to Statement on Auditing Standards No. 1*, Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")*	Amends SAS No. 1, *Due Professional Care in the Performance of Work* (AU section 230)
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards	Amends SAS No. 95, *Generally Accepted Auditing Standards* (AU section 150)
SAS No. 106, *Audit Evidence*	Supersedes SAS No. 31, *Evidential Matter* (AU section 326)
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*	Supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU section 312)
SAS No. 108, *Planning and Supervision*	Supersedes SAS No. 1, *Appointment of the Independent Auditor* (AU section 310); and supersedes SAS No. 22, *Planning and Supervision* (AU section 311)
SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*	Supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU section 319)
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*	Supersedes SAS No. 45, *Substantive Tests Prior to the Balance-Sheet Date* (AU section 313); and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU section 319)
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling	Amends SAS No. 39, *Audit Sampling* (AU section 350)

Key Provisions of the New Standards

The SASs emphasize the link between understanding the entity, assessing risks, and the design of further audit procedures. The SASs introduce the concept of risk assessment procedures, which are deemed necessary to provide a basis for assessing the risk of material misstatement. Risk assessment procedures, along with

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

Effective Date and Implementation

The SASs are effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. In most cases, implementation of the SASs will result in an overall increased work effort by the audit team, particularly in the year of implementation. It also is anticipated that to implement the SASs appropriately, many firms will have to make significant revisions to their audit methodologies and train their personnel accordingly. Readers can obtain the SASs, the related AICPA Audit Risk Alert entitled *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk) and the AICPA Audit Guide entitled *Assessing and Responding to Audit Risk In a Financial Statement Audit* (product no. 012456kk) at www.cpa2biz.com.

Statement on Auditing Standards No. 103

The ASB has issued SAS No. 103, *Audit Documentation*, which supersedes SAS No. 96 of the same name (AICPA, *Professional Standards*, vol. 1, AU sec. 339) and amends AU section 530,

Codification of Auditing Standards and Procedures, (AICPA, *Professional Standards*, vol. 1) "Dating of the Independent Auditor's Report." Effective for audits of financial statements for periods ending on or after December 15, 2006, with earlier application permitted. One key provision of this standard is the amendment of paragraphs .01 and .05 of AU Section 530, which require that "the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion." The footnote to this section describes sufficient appropriate audit evidence as "evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them." Application of the rules may require revising the process used by your firm at the end of fieldwork to include a field review of audit working papers and financial statements. For some firms, an additional visit to the client's office to update subsequent event analysis and management's representations may be required as well.

Statement on Auditing Standards No. 114

The ASB has issued SAS No. 114, *The Auditor's Communication With Those Charged With Governance*, which replaces SAS No. 61, *Communication with Audit Committees*. The new SAS requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit, and also establishes standards and provides guidance on:

- Which matters should be communicated
- Who they should be communicated to, and
- The form and timing of the communication

SAS No. 114 is applicable to audits of the financial statements of all nonissuers and is effective for audits of financial statements for periods beginning on or after December 15, 2006.

AICPA Practice Aid *Alternative Investments—Audit Considerations*

Over the past several years, many companies have dramatically increased their investment in financial instruments that do not have a readily determinable market value (that is, investments not listed on national exchanges or over-the-counter markets, or for which quoted market prices are not available from sources such as financial publications, the exchanges, or the NASDAQ System). This Practice Aid addresses challenges associated with auditing such investments. These investments include private investment funds meeting the definition of an *investment company* under the provisions of the AICPA Audit and Accounting Guide *Investment Companies*, such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity pools, offshore fund vehicles, and funds of funds, as well as bank common/collective trust funds. Collectively, these types of investment funds are commonly referred to as *alternative investments*. Alternative investments may be structured as limited partnerships, limited liability corporations, trusts, or corporations.

This Practice Aid was developed to provide additional guidance to auditors of investor entities as to how the auditor may obtain sufficient appropriate audit evidence in order to conclude that the financial statements are free of material misstatement. This nonauthoritative Practice Aid will assist auditors in auditing alternative investments. The practice aid includes guidance on:

1. General considerations pertaining to auditing alternative investments
2. Addressing management's financial statement existence assertion
3. Addressing management's financial statement valuation assertion
4. Management representations
5. Disclosure of certain significant risks and uncertainties
6. Reporting

The Practice Aid also includes the following Appendixes:

- Appendix 1, "Example Confirmation for Alternative Investments"
- Appendix 2, "Illustrative Examples of Due Diligence, Ongoing Monitoring and Financial Reporting Control"

You can download the practice aid at http://www.aicpa.org/download/members/div/auditstd/Alternative_Investments_Practice_Aid.pdf.

Recent AICPA Independence and Ethics Pronouncements

The AICPA *Independence and Ethics Alert—2006/07* (product no. 022477kk) 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*.

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.

The AICPA general *Audit Risk Alert—2006/07* and other AICPA industry-specific Alerts contain summaries of these recent pronouncements. Some of the recently issued pronouncements that have particular significance to the securities industry are discussed below.

FASB Statement No. 155	*Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140.*
FASB Statement No. 156	*Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*
FASB Statement No. 157	*Fair Value Measurements*
FASB Statement No. 158	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
FASB Interpretation No. 48	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
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). AICPA Technical Practice Aids 2130.09-2130.35 (December 2005) (Nonauthoritative)	Various topics on the application of SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*
AICPA Technical Practice Aids 5600.07-5600.17 (November 2005) (Nonauthoritative)	Various lease topics
AICPA Technical Practice Aid 6910.16-6910.20 (January 2006) (Nonauthoritative)	*Nonregistered Investment Partnerships*
AICPA Technical Practice Aid Working Draft as of December 1, 2006 (December 2006) (Nonauthoritative)	*Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments*

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.

FASB Statement No. 157

On September 15, 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, which provides enhanced guidance for using fair value to measure assets and liabilities. FASB Statement No. 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value and does not expand the use of fair value in any new circumstances. Below is a brief discussion of some of the provisions of FASB Statement No. 157 that should be of interest to broker-dealers and their auditors.

Exit Price Concept

FASB Statement No. 157 clarifies that the exchange price is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the definition focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price).

Fair Value Hierarchy

FASB Statement No. 157 establishes the fair value hierarchy which prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or

liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date.

Measurement of Blocks

Among other matters, FASB Statement No. 157 precludes the use of a blockage factor. Paragraph 27 of FASB Statement No. 157 provides that

> If the reporting entity holds a position in a single financial instrument (including a block) and the instrument is traded in an active market, the fair value of the position shall be measured within Level 1 as the product of the quoted price for the individual instrument times the quantity held. The quoted price shall not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price.

Footnote 11 to this paragraph states that, "The guidance in this Statement applies for positions in financial instruments (including blocks) held by all entities, including broker-dealers and investment companies within the scope of the AICPA Audit and Accounting Guides for those industries."

Nullification of Guidance in Footnote 3 of EITF Issue No. 02-3

The guidance in FASB Statement No. 157 applies for derivatives and other financial instruments measured at fair value under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, at initial recognition and in all subsequent periods. Therefore, FASB Statement No. 157 nullifies the guidance in footnote 3 of Emerging Issues Task Force (EITF) Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in

Energy Trading and Risk Management Activities," which applied for derivatives (and other) instruments measured at fair value at initial recognition under FASB Statement No. 133. That guidance precluded immediate recognition in earnings of an unrealized gain or loss, measured as the difference between the transaction price and the fair value of the instrument at initial recognition, if the fair value of the instrument was determined using significant unobservable inputs. FASB Statement No. 157 provides, however, that for unobservable inputs the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability. Consistent with that objective, FASB Statement No. 157 clarifies that the fair value measurements should be adjusted for risk, that is, the amount market participants would demand because of the risk (uncertainty) inherent in a particular valuation technique used to measure fair value (such as a pricing model) and/or the risk inherent in the inputs to the valuation technique (a risk premium notion). Accordingly, a measurement (for example, a "mark-to-model" measurement) that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one in pricing the related asset or liability.

FASB Statement No. 157 also amends FASB Statement No. 133 to remove the similar guidance to that in EITF Issue No. 02-3, which was added by FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*.

At the 2006 AICPA National Conference on Current SEC and PCAOB Developments, SEC staff provided their views on the impact of FASB Statement No. 157 on the recognition of day one or inception gains. For more information, please refer to Joseph D. McGrath's speech which can be found at http://www.sec.gov/news/speech/2006/spch121106jdm.htm.

Inputs Based on Bid and Ask Prices

FASB Statement No. 157 provides that if an input used to measure fair value is based on bid and ask prices (for example, in a dealer market), the price within the bid-ask spread that is most

representative of fair value in the circumstances should be used to measure fair value, regardless of where in the fair value hierarchy the input falls (Level 1, 2, or 3). FASB Statement No. 157 does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for fair value measurements within a bid-ask spread.

Restricted Assets

FASB Statement No. 157 clarifies that market participant assumptions also include assumptions about the effect of a restriction on the sale or use of an asset. It provides that a fair value measurement for a restricted asset should consider the effect of the restriction if market participants would consider the effect of the restriction in pricing the asset.

Entity's Credit Standing

FASB Statement No. 157 also clarifies that a fair value measurement for a liability reflects its nonperformance risk (the risk that the obligation will not be fulfilled). Because nonperformance risk includes the reporting entity's credit risk, the reporting entity should consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value under other accounting pronouncements, including FASB Statement No. 133.

Disclosures

FASB Statement No. 157 also expands disclosures about the use of fair value to measure assets and liabilities in interim and annual periods subsequent to initial recognition. The disclosures focus on the inputs used to measure fair value and for recurring fair value measurements using significant unobservable inputs (within Level 3 of the fair value hierarchy), the effect of the measurements on earnings (or changes in net assets) for the period. FASB Statement No. 157 encourages entities to combine the fair value information disclosed under FASB Statement No. 157 with the fair value information disclosed under other accounting pronouncements, including FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, where practicable.

Effective Date

FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year.

You can access FASB Statement No. 157 at http://www.fasb.org/pdf/fas157.pdf.

FASB Statement No. 156

In March of 2006, the FASB issued FASB Statement No. 156, *Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*, which simplifies the accounting for servicing assets and liabilities, such as those common with mortgage securitization activities. Specifically, FASB Statement No. 156 addresses the recognition and measurement of separately recognized servicing assets and liabilities and permits an entity to elect to carry servicing assets and liabilities at fair value through earnings, which may simplify efforts to obtain hedge-like accounting.

This Statement:

1. Requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in any of the following situations:
    - *a.* A transfer of the servicer's financial assets that meets the requirements for sale accounting
    - *b.* A transfer of the servicer's financial assets to a qualifying special-purpose entity (QSPE) in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities and classifies them as either available-for-sale securities or trading securities in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*

   c. An acquisition or assumption of an obligation to service a financial asset that does not relate to financial assets of the servicer or its consolidated affiliates.

2. Requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable.
3. Permits an entity to choose either of the following subsequent measurement methods for each class of separately recognized servicing assets and servicing liabilities:
   a. *Amortization method*—Amortize servicing assets or servicing liabilities in proportion to and over the period of estimated net servicing income or net servicing loss and assess servicing assets or servicing liabilities for impairment or increased obligation based on fair value at each reporting date.
   b. *Fair value measurement method*—Measure servicing assets or servicing liabilities at fair value at each reporting date and report changes in fair value in earnings in the period in which the changes occur.
4. At its initial adoption, permits a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights, without calling into question the treatment of other available-for-sale securities under FASB Statement No. 115, provided that the available-for-sale securities are identified in some manner as offsetting the entity's exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value.
5. Requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities.

Entities should adopt FASB Statement No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006.

Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including interim financial statements, for any period of that fiscal year.

You can access FASB Statement No. 156 at http://www.fasb.org/pdf/fas156.pdf.

FASB Statement No. 155

General Provisions of FASB Statement No. 155

In February of 2006, the FASB issued FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statement No. 133 and 140*, which allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. FASB Statement No. 155 also:

a. Clarifies which interest-only strips and principal-only strips are not subject to the requirements of FASB Statement No. 133

b. Eliminates the exemption from FASB Statement No. 133 for interests in securitized financial assets provided temporarily by Implementation Issue D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," and establishes a requirement to evaluate those interests to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation

c. Clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives

d. Amends paragraphs 35(c)(2) and 40 of FASB Statement No. 140 to eliminate the prohibition on a QSPE from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument.

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

You can access FASB Statement No. 155 at http://www.fasb.org/pdf/fas155.pdf.

On November 8, 2006, the FASB issued proposed FASB Statement No. 133 Implementation Issue No. B40, *Application of Paragraph 13(b) to Securitized Interest in Prepayable Financial Assets*, to provide guidance on implementation issues related to FASB Statement No. 155. Please refer to the "On the Horizon" section of this Alert for a discussion of this proposed Implementation Issue.

FASB Interpretation No. 48

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109*. FASB Interpretation No. 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The standard also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

FASB Interpretation No. 48 was issued to reduce the significant diversity in practice. A company's tax positions can change over time from a myriad of variables, for example, Internal Revenue Service (IRS) developments, state taxing authorities, and/or tax court cases. Companies were recording uncertainties in differ-

ent ways. Some companies had been assessing a position being supported under a tax audit, some had also included the probability of an audit, and some companies simply recorded tax assets and liabilities based on what was filed on their returns. Additionally, some companies recorded tax reserves for contingent tax liabilities.

The scope of FASB Interpretation No. 48 applies to all tax positions. The Interpretation assumes that a company cannot factor in the probability of being audited. Therefore, for purposes of determining the likelihood of being sustained, the taxpayer has to presume the position will be examined by taxing authorities. Consequently, the tax benefit of a position that would not be sustained under audit cannot be recorded.

Prior to the issuance of FASB Interpretation No. 48, management's common approach was to create an inventory of uncertain tax positions and evaluate them under FASB Statement No. 5, *Accounting for Contingencies*. Because FASB Interpretation No. 48 now provides guidance, FASB Statement No. 5 no longer applies to uncertain tax positions. However, for clarification, FASB Interpretation No. 48 does not in any way alter the requirement in FASB Statement No. 109, *Accounting for Income Taxes*, to assess the need for a valuation allowance for deferred tax assets.

Only tax positions that meet the more likely than not recognition threshold, as defined, may be recognized or continue to be recognized upon adoption of FASB Interpretation No. 48. The cumulative effect of applying the Interpretation for the first time is reported as an adjustment to the opening balance of retained earnings for that fiscal year, presented separately. This Interpretation is effective for fiscal years beginning after December 15, 2006. Earlier application of its provisions is encouraged if the enterprise has not yet issued financial statements, including interim financial statements, in the period adopted.

For calendar year corporations, the new rules would seem to initially take effect with first quarter 2007 results. However, the new rules require calendar year corporations to have a "clean" starting point for their tax accounts at January 1, 2007. In other words,

the deferred tax asset and deferred tax liability accounts on that date must be determined in accordance with the standards of FASB Interpretation No. 48. Note that companies that do not file quarterly reports may be able to put compliance off for a year.

The IRS has recognized that some taxpayers may wish to request a greatly accelerated examination and resolution before the end of their current fiscal year of "uncertain tax positions" taken in filed returns and/or expected to be taken in tax returns yet to be filed. According to information received by the AICPA, the IRS has put procedures in place to quickly respond to taxpayer requests to resolve some uncertain tax positions prior to the end of their current fiscal year. The IRS has provided guidance and direction to field teams for taxpayers under examination which can be viewed at http://www.irs.gov/businesses/corporations/article/0,,id=163496,00.html. The IRS has also established procedures for taxpayers whose returns are not under examination as well as for taxpayers whose returns have not yet been filed.

Practitioners may find it helpful to refer to the recently issued AICPA *Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48*, which includes highlights of the Interpretation and its implications for in-house accountants, auditors, and tax advisers. It is not authoritative, but intended to assist practitioners in quickly understanding the requirements of FASB Interpretation No. 48. The Practice Guide can be accessed at http://tax.aicpa.org/Resources/Professional+Standards+and+Ethics/Practice+Guide+on+Accounting+for+Uncertain+Tax+Positions+Under+FIN+48.htm.

FASB Staff Position FIN 46(R)-6

Background

There is diversity in practice in determining the variability that should be considered in applying FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FASB Interpretation No. 46(R)). For example, some believe that only the variability that results from changes in cash flows (referred to as the *cash flow method*) should be considered, while others believe that only the variability that results from changes

in fair value (referred to as the *fair value method*) should be considered. In applying FASB Interpretation No. 46(R), a reporting enterprise may have—but not always—reached the same conclusion as to whether the entity is a variable interest entity (VIE) and which interests should be considered variable interests regardless of the method used.

An entity may enter into an arrangement, such as a derivative contract, to either reduce or eliminate (1) the variability created by certain assets or operations of the entity or (2) mismatches between the overall asset and liability profiles of the entity, thereby protecting certain liability and equity holders from exposure to such variability. During the life of the entity, those arrangements can be in either an asset position or a liability position (recorded or unrecorded) from the perspective of the entity. Currently, there is diversity in practice as to whether these arrangements should be treated as variable interests or considered as creators of variability. In certain cases, application of either the cash flow method or the fair value method will not result in a clear determination as to whether those arrangements are variable interests or creators of variability.

FASB Staff Position

FASB Staff Position (FSP) FIN 46(R)-6, *Determining the Variability to Be Considered in Applying FASB Interpretation No. 46(R)*, issued on April 13, 2006, addresses how a reporting enterprise should determine the variability to be considered in applying Interpretation 46(R). The variability that is considered in applying Interpretation 46(R) affects the determination of (1) whether the entity is a VIE, (2) which interests are variable interests in the entity, and (3) which party, if any, is the primary beneficiary of the VIE. That variability will affect any calculation of expected losses and expected residual returns, if such a calculation is necessary.

FSP FIN 46(R)-6 provides that the variability to be considered in applying FASB Interpretation No. 46(R) should be based on an analysis of the design of the entity as outlined in the following steps:

- *Step 1.* Analyze the nature of the risks in the entity (paragraphs 6 and 7 of this FSP).
- *Step 2.* Determine the purpose(s) for which the entity was created and determine the variability (created by the risks identified in Step 1) the entity is designed to create and pass along to its interest holders (paragraphs 8-14 of this FSP).

For the purposes of this FSP, interest holders include all potential variable interest holders (including contractual, ownership, or other pecuniary interests in the entity). After determining the variability to consider, the reporting enterprise can determine which interests are designed to absorb that variability. The cash flow and fair value methods described in this FSP are examples of methods that can be used to measure the amount of variability (that is, expected losses and expected residual returns) of an entity. However, a method that is used to measure the amount of variability does not provide an appropriate basis for determining which variability should be considered in applying FASB Interpretation No. 46(R).

An enterprise should apply the guidance in FSP FIN 46(R)-6 prospectively to all entities (including newly created entities) with which that enterprise first becomes involved and to all entities previously required to be analyzed under FASB Interpretation No. 46(R) when a reconsideration event has occurred pursuant to paragraph 7 of FASB Interpretation No. 46(R) beginning the first day of the first reporting period beginning after June 15, 2006. Early application is permitted for periods for which financial statements have not yet been issued. Retrospective application to the date of the initial application of FASB Interpretation No. 46(R) is permitted but not required. Retrospective application, if elected, must be completed no later than the end of the first annual reporting period ending after July 15, 2006.

Please refer to http://www.fasb.org/fasb_staff_positions/fsp_fin46r-6.pdf for a complete text of this FSP.

AICPA Technical Practice Aid *Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments*—working draft as of December 1, 2006

This Technical Practice Aid was prepared by the Analyzing Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments Task Force and the staff of the AICPA. This Technical Practice Aid is a working draft and the content reflects what the authors believe is existing authoritative literature as of December 1, 2006. Readers are reminded that there are several projects currently in process at the FASB that may affect the contents of this Technical Practice Aid and they must be alert to any changes. This Technical Practice Aid has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA or the FASB or the staff of the SEC and has no official or authoritative status.

Financial instruments that are indexed to and potentially settled in a company's own stock have become increasingly popular in the current financial markets. These financial instruments may be either freestanding or embedded in the structure of other financial instruments. Examples of freestanding instruments include written and purchased stock options, forward stock purchase/sale contracts, and various combinations of these instruments. Examples of embedded features that may require bifurcation include conversion options in convertible debt. Preparers and auditors of financial statements often need to decide whether these financial instruments, or some component of those financial instruments, qualify for classification in stockholders' equity (or nonbifurcation if the instrument is an embedded derivative) or should be accounted for as a financial asset or liability.

The FASB currently has a long-term project on its agenda to develop a comprehensive standard of accounting and reporting for financial instruments with characteristics of liabilities and equity, in addition to several short-term projects under consideration. In the absence of a single comprehensive accounting standard for such instruments, the existing accounting literature was developed in a largely piecemeal fashion, by various standard-setting

bodies, often in response to specific instruments that have been observed in the marketplace.

Practitioners often find it difficult to navigate standards relevant to these financial instruments, particularly because two or three of these standards must often be considered in contemplation of one another before reaching a final conclusion on the appropriate accounting for a financial instrument. The interaction between these standards, coupled with the complex nature of financial instruments, requires that practitioners be familiar with complex accounting rules and possess knowledge of the various common types of financial instruments. In addition, analyzing these financial instruments requires that practitioners exercise significant judgment on complex accounting issues.

This Technical Practice Aid is not intended to provide practitioners with interpretative guidance or to describe the accounting for specific instruments. Rather, it is intended to assist practitioners in identifying the scope of and the interrelationships between the various relevant accounting pronouncements. To accomplish that goal, the Practice Aid is a roadmap addressing the accounting considerations that should be considered in analyzing freestanding and embedded derivative financial instruments at issuance and on an ongoing basis.

This Practice Aid is available at http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/Working+Draft+of+Convertible+Debt+Convertible+Preferred+Shares+Warrants+and+Other+Equi.htm.

SEC Staff Accounting Bulletins

Auditors of public companies and of those companies that file with the SEC need to consider the accounting and financial reporting requirements contained in the SEC regulations as well as requirements imposed upon auditors. Currently, public companies must adhere to the requirements set forth in SEC Staff Accounting Bulletins (SABs), but private companies are not bound by them. However, with respect to SAB No. 108, Topic 1N *Considering the Effects of Prior Year Misstatements when Quantifying*

Misstatements in Current Year Financial Statements, which is discussed below, on December 19, 2006, the FASB said it would issue guidance specifying that private companies should use the same methods as public companies to evaluate the materiality effects of prior-year adjustments on current year financial statements. FASB said it would incorporate the concepts from SAB No. 108 as part of a narrow scope look at the issue in either a FASB staff position or an interpretation. The FASB said it also would issue guidance modifying current standards to allow for a one-time cumulative-effect adjustment for private companies to correct misstatements resulting from the carryover or reversal of prior year misstatements.

The summary below is for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable rules. See the SEC Web site at www.sec.gov for complete information.

Staff Accounting Bulletin No. 108

On September 13, 2006, the SEC released SAB No. 108. The issuance provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current-year misstatement.

There have been two common approaches used to quantify such errors. Under one approach, the error is quantified as the amount by which the current-year income statement is misstated (rollover approach). The other common approach quantifies the error as the cumulative amount by which the current-year balance sheet is misstated (iron curtain approach). Exclusive reliance on an income statement approach can result in a registrant accumulating errors on the balance sheet that may not have been material to any individual income statement, but which nonetheless may misstate one or more balance sheet accounts. Similarly, exclusive reliance on a balance sheet approach can result in a registrant disregarding the effects of errors in the current-year income statement that result from the correction of an error existing in previously issued financial statements.

The staff believes registrants must quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior-year misstatements, on the current-year financial statements. The SEC staff believes that this can be accomplished by quantifying errors under both a balance sheet and an income statement approach and by evaluating errors measured under each approach. Thus, a registrant's financial statements would require adjustment when either approach results in quantifying a material misstatement after considering all relevant quantitative and qualitative factors.

If, in correcting an error in the current year, an error is material to the current-year's income statement, the prior-year financial statements should be corrected, even though such a revision previously was and continues to be immaterial to the prior-year financial statements. Correcting prior-year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior-year financial statements. However, registrants electing not to restate prior periods should follow the disclosure requirements specified in the SAB. In general, SAB No. 108 is effective for financial statements for fiscal years ending after November 15, 2006, with earlier application encouraged in any report for an interim period of the first fiscal year ending after November 15, 2006, and filed after the SAB's publication date of September 13, 2006. For additional accounting and transition information, please refer to the full text of SAB No. 108 at www.sec.gov/interps/account/sab108.pdf.

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 generally accepted auditing standards (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, he Public Company Accounting Oversight Board sets auditing standards.)	http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/
Public Company Accounting Oversight Board (PCAOB)	www.pcaobus.org
AICPA Accounting Standards Executive Committee (AcSEC)	http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
Financial Accounting Standards Board (FASB)	www.fasb.org
Professional Ethics Executive Committee (PEEC)	http://www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/

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.

Proposed FASB Statement, *Accounting for Transfers of Financial Assets*

On August 11, 2005, the FASB issued an exposure draft of a proposed Statement, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*. 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 (1) clearly specify the circumstances that require the use of a QSPE in order to derecognize all or a portion of financial assets, (2) provide additional guidance on permitted activities of QSPEs, (3) eliminate the prohibition on a QSPE's ability to hold passive derivative financial instruments that pertain to beneficial interests held by a transferor, and (4) revise the initial measurement of interests related to transferred financial assets held by a transferor.

During redeliberations of this proposed Statement the FASB decided to amend the isolation criteria in paragraph 9(a) of FASB Statement No. 140 for consolidated financial statements that include a transferor by requiring that the legal analysis treat all of the involvements in the transferred financial assets by any entity that is included in the consolidated financial statements being presented as if those involvements were made by the transferor. In order for a parent entity of a transferor to meet the isolation requirement, an isolation analysis must conclude that the transferred financial assets would be beyond the reach of all of the entities (and their creditors) included in the financial statements being presented, using the assumption that all of the involvements of the entities were made by the 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 its deliberations at http://www.fasb.org/project/transfers_of_financial_assets.shtml.

Proposed FASB Statement, *The Fair Value Option for Financial Assets and Financial Liabilities*

In January 2006, the FASB issued an exposure draft of a proposed Statement, *The Fair Value Option for Financial Assets and Financial Liabilities*. The fair value option project has two phases: This proposed Statement represents Phase 1, which addresses the fair value option for certain financial assets and financial liabilities. Phase 2 will consider permitting the fair value option for certain nonfinancial assets and nonfinancial liabilities and some of the financial assets and financial liabilities excluded from the scope of Phase 1.

This proposed Statement would create a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities, with changes in fair value recognized in earnings as those changes occur. An entity would be permitted to elect the fair value option at initial recognition of a financial asset or financial liability or upon an event that gives rise to new-basis accounting for that item. The election of the fair value option would be made on a contract-by-contract basis and would need to be supported by concurrent documentation or a preexisting documented policy.

This proposed Statement would require an entity to report its financial assets and financial liabilities that, pursuant to electing the fair value option, would be subsequently measured at fair value in a manner that separates those reported fair values from the carrying amounts of assets and liabilities subsequently measured using another measurement attribute on the face of the statement of financial position. To accomplish that separate reporting, an entity would either (1) display separate line items for the fair value and nonfair-value carrying amounts or (2) present the aggregate of those fair value and nonfair-value amounts and disclose parenthetically the amount of fair value included in the aggregate amount. This proposed Statement would amend FASB Statement No. 115, *Accounting for Certain Investments in Debt*

and Equity Securities, to require that securities reported at fair value in accordance with FASB Statement No. 115 satisfy this financial statement presentation requirement.

This proposed Statement would also require an entity to provide information that would allow users to understand the effect on earnings of changes in the fair values of assets and liabilities subsequently measured at fair value as a result of a fair value election.

It is expected that *The Fair Value Option* Statement will have the same effective date as the effective date of FASB Statement No. 157; that is, effective for financial statements issued for fiscal years beginning after November 15, 2007. Entities will be permitted to early adopt *The Fair Value Option* Statement provided that the entity also adopts all of the requirements (measurement and disclosure) of FASB Statement No. 157 concurrent with or prior to the early adoption of *The Fair Value Option* Statement.

You can access this exposure draft at http://www.fasb.org/draft/ed_fair_value_option.pdf and get updated information on the status of this project at http://www.fasb.org/project/fv_option.shtml.

Proposed FASB Statement, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*

On December 8, 2006, FASB issued an exposure draft of a proposed Statement, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*, which would amend and expand the disclosure requirements in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and other related literature. This proposed Statement would enhance the current disclosure framework by requiring that objectives and strategies for using derivative instruments be discussed in terms of underlying risk and accounting designation. The exposure draft would require tabular disclosure of notional and fair value amounts of derivatives instruments and the gains and losses on derivatives instruments and related hedged items. Additionally, the proposed Statement would

require disclosure of information about counterparty credit risk and the existence and nature of contingent features in derivative instruments.

The requirements of the proposed Statement would be effective for financial statements issued for fiscal years and interim periods ending after December 15, 2007, with early application encouraged. The proposed Statement would encourage but would not require disclosures for earlier periods at initial adoption. In years after initial adoption, the proposed Statement would require disclosures for earlier periods.

You can access this exposure draft at http://www.fasb.org/draft/ed_derivatives_disclosure.pdf and get updated information on the status of this project at http://www.fasb.org/project/derivative_disclosures.shtml. Comment deadline is March 2, 2007.

EITF Issue No. 06-12, *Application of AICPA Audit and Accounting Guide*, Brokers and Dealers in Securities, *to Entities That Engage in Commodity Trading Activities and Related Issues*

At its November 16, 2006, meeting, the EITF discussed Issue No. 06-12, *Application of AICPA Audit and Accounting Guide*, Brokers and Dealers in Securities, *to Entities That Engage in Commodity Trading Activities and Related Issues*.

The landscape for the commodities trading market continues to expand both in volume and in diversity of market participants. Although some global investment banks and energy companies have been trading a wide range of energy-related products (and other physical commodities) for many years, other financial intermediaries have become increasingly active over the last several years in the energy trading markets. Traditionally, the product offerings were primarily focused on financial products including those based on crude oil, natural gas, power, coal, and base metals; in addition to market making, speculation, and risk management trading activities. Recently, these other financial intermediaries have expanded their portfolios to incorporate the purchase and sale of commodities by taking physical delivery of

the underlying commodity. These entities may or may not be regulated as a broker-dealer.

Although GAAP applies to broker-dealers in the same manner as it applies to other industries, certain activities of a broker-dealer's operations are unique. For this reason, the Broker Dealer Guide provides certain interpretations and other guidance specific to broker-dealers. Determining whether an entity is within the scope of the Broker Dealer Guide is significant because it provides a specialized accounting model. One important difference in financial reporting for entities within the scope of the Broker Dealer Guide is the requirement to carry inventory at fair value.

The specific accounting requirements for a broker-dealer make it important to consistently determine whether an entity is within the scope of the Broker Dealer Guide, which states:

> This Guide applies to preparation and audit of financial statements of entities that are broker-dealers in securities. The activities of broker-dealers in securities are described in Chapter 1. Operations of such entities are subject to the rules and regulations of the Securities and Exchange Commission and other regulatory bodies.
>
> Broker-dealers in securities are subject to regulation under the Securities Exchange Act of 1934. Some broker-dealers are also futures commission merchants for commodity futures and commodity option contracts subject to regulation under the Commodity Exchange Act.

In practice, diversity exists regarding the interpretation of the type of entity that can apply the Broker Dealer Guide. Some believe the Broker Dealer Guide is only applicable to entities that are regulated as broker-dealers under the Exchange Act, while others believe the Broker Dealer Guide is applicable based on the activity of the entity, if the activities of the entity are similar to those of a regulated broker-dealer. Entities that qualify as a consolidated supervised entity have applied the Broker Dealer Guide under an activities-based approach to nonregulated subsidiaries (or subsidiaries regulated in other jurisdictions) that conduct activities similar or identical to regulated broker-dealers. The SEC has prohibited certain other entities that are not subject to

regulation as a broker-dealer under the 1934 Act from applying the Broker Dealer Guide under an activities-based approach on the basis that their organizations are predominantly financial institutions (conducting banking activities) that are subject to the banking regulations.

In addition to the identification of the type of entity that can apply the Broker Dealer Guide, diversity exists on whether entities that are within the scope of the Broker Dealer Guide should be accounting for physical commodity inventory at fair value. Many entities (both those that are and those that are not regulated) that are applying the Broker Dealer Guide believe that physical commodity positions (such as natural gas, crude oil, and so forth) should be recorded at fair value based on an interpretation of the Broker Dealer Guide that allows all trading inventory to be measured at fair value.

Although inventory is not specifically defined in the Broker Dealer Guide, industry practice has been to use references linked to the Broker Dealer Guide to interpret the definition of inventory as all trading positions, including financial instruments and physical commodities, that are held for sale to customers in connection with market making activities, as proprietary positions, or to economically hedge risks inherent in both.

However, paragraph 17 of EITF Issue No. 02-3 prohibits fair value accounting for nonderivative contracts. The consensus in EITF Issue No. 02-3 observes that prior to EITF Issue No. 02-3, broker-dealers carried physical commodity inventory at fair value. However, EITF Issue No. 02-3 eliminated "any basis for recognizing physical inventories at fair value, except as provided by other guidance under higher categories of the GAAP hierarchy." Furthermore, Chapter 4, *Inventory Pricing*, of Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins* (ARB 43), has historically been the accounting guidance applied to measure commodity inventory for most nonregulated broker-dealers. ARB 43 describes inventory held for sale in the ordinary course of business and requires that inventory be recognized at cost less impairment; however, ARB 43 allows an exception in Chapter 4, Statement 9, which states, in part:

> Only in exceptional cases may inventories properly be stated above cost. For example, precious metals having a fixed monetary value with no substantial cost of marketing may be stated at such monetary value; any other exceptions must be justifiable by inability to determine appropriate approximate costs, immediate marketability at quoted market price, and the characteristic of unit interchangeability.

The SEC has further interpreted ARB 43 to imply that recognition of inventory above cost should be rare. Many times, energy-based financial products are marked-to-market because they meet the definition of a derivative (including physically settled contracts that meet the requirements of FASB Statement No. 133). However, since the Broker Dealer Guide provides specialized accounting guidance that may not be specifically addressed by ARB 43, entities that qualified for the Broker Dealer Guide have applied the provisions of the Broker Dealer Guide as it relates to inventory.

Energy companies that conduct similar commodities trading activities do not fair value their physical commodity inventory since they have historically been considered outside the scope of the Broker Dealer Guide and do not meet the guidance in Chapter 4, Statement 9, of ARB 43. These entities contend that they are at a competitive disadvantage since their energy trading subsidiaries are conducting activities similar to those of a regulated broker-dealer, but have no basis to support fair value accounting recognition.

EITF Issue No. 06-12 will address the following two accounting issues:

- *Issue 1.* How to determine whether an entity is included within the scope of the Broker-Dealer Guide
- *Issue 2.* Whether entities within the scope of the Broker-Dealer Guide should record physical commodity inventory at fair value

At the November 16, 2006, meeting the EITF deferred making a decision on this Issue and recommended that the FASB address the accounting for traded physical commodity inventory through

the issuance of an FSP. The EITF also recommended that the FASB consider amending ARB 43, Chapter 4, "Inventory Pricing," to remove any perceived conflict with the Broker-Dealer Guide in the accounting for physical commodity inventory as part of the proposed FSP. At a future meeting, the EITF will evaluate whether it is necessary to continue discussing this Issue after considering the FASB's decision on whether to add the recommended project to the FASB's agenda. In the event that the EITF decides to continue discussing this Issue, the EITF requested that the staff further explore the criteria used to determine the application of an activities-based approach to interpreting whether an entity should be included within the scope of the Broker-Dealer Guide.

For more information on this Issue, please refer to the "Issue Summary" that was presented to the EITF in November and which can be accessed at http://www.fasb.org/eitf/IS0612WW.pdf.

Proposed FASB Staff Position FIN 39-a, *Amendment of FASB Interpretation No. 39*

On December 13, 2006, the FASB issued a proposed FSP FIN 39-a that addresses:

a. Certain modifications to FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*

b. Whether a reporting entity that is party to a master netting arrangement[1] can offset the receivable or payable recognized upon payment or receipt of cash collateral[2] against fair value amounts recognized for derivative instruments that have been offset under the same master netting arrangement in accordance with paragraph 10 of Interpretation 39.

Specifically, this FSP amends paragraph 3 to replace the terms *conditional contracts* and *exchange contracts* with the term *derivative instruments* as defined in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and paragraph 10 to permit a reporting entity to offset fair value

amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) against fair value amounts recognized for derivative instruments executed with the same counterparty under the same master netting arrangement that have been offset in accordance with paragraph 10 of Interpretation 39.

The guidance in this proposed FSP would be effective for fiscal years beginning after December 15, 2006. A reporting entity would recognize the effects of applying this FSP as a change in accounting principle through retrospective application for all financial statements presented unless it is impracticable to do so. If a reporting entity determines it is impracticable to retrospectively apply the guidance in this FSP for all financial statements presented, the reporting entity would disclose why it is impracticable and apply the guidance in this FSP retrospectively for as many consecutive prior financial statements as practicable. Upon adoption of this FSP, a reporting entity would be permitted to change its accounting policy to offset or not offset fair value amounts recognized for derivative instruments under master netting arrangements.

For the full text of this FSP, please refer to the FASB Web site at http://www.fasb.org/fasb_staff_positions/prop_fsp_fin39a.pdf.

Proposed FASB Statement No. 133 Implementation Issue No. B40, *Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets*

On November 8, 2006, the FASB issued proposed FASB Statement No. 133 Implementation Issue No. B40, *Application of Paragraph 13(b) to Securitized Interest in Prepayable Financial Assets*, with an accelerated 30-day public comment period that ended on December 6, 2006.

The objective of this project is to provide guidance on implementation issues related to FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*, which have been raised by constituents. Specifically, the proposed Implementation Issue clarifies that a securitized interest in prepayable financial assets

would not be subject to the conditions in paragraph 13(b) of FASB Statement No. 133 if it meets specified criteria.

The provisions in the proposed Implementation Issue would be effective upon initial adoption of FASB Statement No. 155. An entity that adopted FASB Statement No. 155 prior to December 31, 2006, would apply the guidance in the first reporting period beginning before December 31, 2006 for which financial statements have not yet been issued.

You can access this proposed Implementation Issue at http://www.fasb.org/derivatives/11-08-06.pdf and get updated information on the status of this project at http://www.fasb.org/project/st155_implementation_issues.shtml.

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 13, 2006, meeting, the FASB met with representatives of the AICPA's Accounting Standards Executive Committee (AcSEC) and discussed final clearance of the AICPA Statement of Position (SOP), *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*. The FASB did not object to issuance of that final SOP. AcSEC expects to issue the final SOP by March 2007.

This SOP provides guidance for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies*. For those entities that are investment companies under this SOP, this SOP also addresses whether the specialized industry accounting principles of the guide (referred to as *investment company accounting*) should be retained by a parent company in consolidation or by an investor 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 (referred to as an *equity method investor*). In addition,

this SOP includes certain disclosure requirements for parent companies and equity method investors in investment companies that retain investment company accounting in the parent company's consolidated financial statements or the financial statements of an equity method investor.

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 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.

Practitioners in the industry are concerned that those provisions are overly strict and would prohibit a company from using investment company accounting if it has an investment through an investment company and simultaneously has a direct investment in that same or similar investment. According to the notes of the

September 13, 2006, FASB meeting, the FASB staff discussed that concern with some of those constituents. The staff believes that the proposed SOP is operational as written.

Some broker-dealers have real estate and other investment type vehicles that might be affected by the applicability of the new scope of the Investment Companies guide. The proposed SOP includes Appendix C, "Applying the Provisions of this Statement of Position to Entities That Hold Investments in Real Estate," which discusses the application of the provisions of this SOP to entities that hold investments in real estate. Certain entities that hold investments in real estate may meet the definition of an *investment company*. Paragraph 5 of the proposed SOP defines an investment company, in part, as a "separate legal entity whose business purpose and activity are investing in multiple substantive investments for current income, capital appreciation, or both, with investment plans that include exit strategies." The proposed SOP includes no specific conclusions applicable to entities that own direct interests in real estate. Entities with direct interests in real estate should consider whether the entity's activities pertaining to those investments would result in the entity not meeting the definition of an *investment company*. Appendix C should help practitioners in determining whether the entity is a real estate investment company (an investment company that holds direct ownership of real estate) or an operating company (not an investment company).

The proposed SOP is expected to become effective for fiscal years beginning on or after December 15, 2007, with earlier application encouraged. You can access the most recent draft of the SOP updated as of August 15, 2006, at http://www.aicpa.org/download/acctstd/investment_cos_scope_SOP71.pdf.

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 FCMs, IBs, 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 have occurred since the original issuance of this publication. The revised practice aid will provide practitioners with nonauthoritative, practical guidance on auditing financial statements of FCMs, IBs, and commodity pools. Readers should be alert to further developments.

Auditing Pipeline—Nonpublic Companies

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

In January 2006, the ASB issued a revised exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE) that would supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Engagements: Revision and Recodification* (AICPA, *Professional Standards*, vol. 2, AT sec. 501), as amended. This proposed 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). In May 2006, the PCAOB announced plans to amend certain aspects of PCAOB Auditing Standard No. 2 to improve its implementation. Because the forthcoming changes to the PCAOB Standard will be relevant to the revision of AT Section 501, the ASB has decided to defer the issuance of a final revised AT Section 501 until the PCAOB issues their amendments and the ASB has time to consider them. For additional information, see the section, "FDICIA Update—What's New (or Not) for 2006?"

Proposed *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) 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.

Auditing Pipeline—Public Companies

In addition to reading about the matters presented below, see the AICPA *SEC and PCAOB Alert—2006/2007* (product no. 022497kk) for a detailed overview of recent developments at the SEC and PCAOB with respect to financial reporting and auditing matters.

Proposed PCAOB Auditing Standard, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements*

This proposed standard would supersede PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, AU sec. 320), and is designed to focus the auditor on the matters most important to internal control; eliminate unnecessary procedures; simplify and shorten the standard by reducing detail and specificity; and make the audit more scalable for smaller and less complex companies. Among other things, the proposed standard would:

- Direct the auditor to the most important controls and emphasize the importance of risk assessment;
- Revise the definitions of significant deficiency and material weakness, as well as the "strong indicators" of a material weakness;
- Clarify the role of materiality, including interim materiality, in the audit;
- Remove the requirement to evaluate management's process;
- Permit consideration of knowledge obtained during previous audits;
- Direct the auditor to tailor the audit to reflect the attributes of smaller and less complex companies;
- Refocus the multilocation testing requirements on risk rather than coverage; and
- Recalibrate the walkthrough requirement.

The PCAOB is also seeking comment on certain related proposals that would facilitate the PCAOB's efforts to make audits of internal control more effective and efficient. These related proposals are described below.

Proposed PCAOB Auditing Standard, *Considering and Using the Work of Others*

This proposed standard would supersede AU sec. 322 (AICPA, *PCAOB Standards and Related Rules*) and the direction currently contained in PCAOB Auditing Standard No. 2 regarding using the work of others. Among other things, the proposed standard would:

- Allow the auditor to appropriately use the work of others, and not just internal auditors, for both the internal control audit and the financial statement audit, eliminating a barrier to integration of the two audits;

- Encourage greater use of the work of these others by requiring auditors to evaluate whether and how to use their work to reduce auditor testing;
- Require the auditor to understand the relevant activities of these others and determine how the results of that work may affect the audit;
- Provide a single framework for using the work of others based on the auditor's evaluation of the combined competence and objectivity of others and the subject matter being tested; and
- Eliminate the explicit principal evidence provision previously included in PCAOB Auditing Standard No. 2.

Proposed Rule 3525, *Audit Committee Pre-approval of Services Related to Internal Control*

The proposed new independence rule would replace direction currently contained in PCAOB Auditing Standard No. 2 regarding independence and internal control-related services. The proposed rule is intended to ensure that audit committees are provided relevant information for them to make an informed decision on how the performance of internal control-related services may affect independence. The new rule would also recognize that audit committees may pre-approve the provision by their independent auditor of internal control-related services on an ad hoc (i.e., specific to each request) basis, or pursuant to committee-approved policies and procedures.

Proposed Amendments to PCAOB Interim Standards

The PCAOB proposed amendments that, among other things, would:

- Simplify the internal control standard by moving certain information currently contained in PCAOB Auditing Standard No. 2 to other existing interim standards. For example, the proposed amendments would move the auditor's responsibilities for management's internal control

certifications under Section 302 of the Act into AU sec. 722, *Interim Financial Information* (AICPA, *PCAOB Standards and Related Rules*); and

- Change the existing requirement that "generally, the date of completion of the field work should be used as the date of the independent auditor's report" to "the auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion."

Comments on these proposals should be received no later than February 26, 2007. The proposed standards and related documents are available on the PCAOB's Web site under Rulemaking Docket 21.

SEC Proposed Guidance on *Management's Report on Internal Control Over Financial Reporting*

In addition to reading about the proposal discussed below, see the AICPA *SEC and PCAOB Alert—2006/2007* (product no. 022497kk) for a detailed overview of recent developments at the SEC and PCAOB with respect to financial reporting and auditing matters.

On December 20, 2006, the SEC proposed interpretive guidance for management regarding its evaluation of internal control over financial reporting. The interpretive guidance sets forth an approach by which management can conduct a top-down, risk-based evaluation of internal control over financial reporting. The proposed guidance is intended to assist companies of all sizes to complete their annual evaluation in an effective and efficient manner and it provides guidance on a number of areas commonly cited as concerns over the past two years. In addition, the SEC proposed an amendment to its rules requiring management's annual evaluation of internal control over financial reporting to make it clear that an evaluation that complies with the interpretive guidance is one way to satisfy those rules. Further, the SEC proposed an amendment to its rules to revise the requirements regarding the auditor's attestation report on the

assessment of internal control over financial reporting. Under the proposed rule amendments, the auditor would express only a single opinion on the effectiveness of the company's internal controls in its attestation report rather than expressing separate opinions directly on the effectiveness of the company's internal control over financial reporting and on management's assessment. In addition, the proposed rule amendments would clarify the circumstances in which the SEC would expect that the accountant cannot express an opinion.

Comments on this proposal should be received on or before February 26, 2007. Please see Release No. 33-8762 for more information.

Resource Central

On the Bookshelf

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

- Audit and Accounting Guide *Brokers and Dealers in Securities* (product no. 012706kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012526kk)
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012516kk)
- Audit Guide *Audit Sampling* (product no. 012530kk)
- Audit Guide *Analytical Procedures* (product no. 012556kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, As Amended* (product no. 012776kk)
- *Accounting Trends & Techniques—2006* (product no. 009898kk)

- 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. 005136kk) 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* (2006 edition) (product no. 736182kk, 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. 731813kk, text; for product numbers for other formats please refer to the cpa2biz.com 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. 730277kk). 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. 730546kk). 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. 739175kk). 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. 736773kk, text; for product numbers for other formats, please refer to the cpa2biz.com 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. 732551kk). This course provides 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 2006 AICPA CPE Catalog* and *Accounting and Auditing CPE Catalog*, which are available at https://www.cpa2biz.com/CPE/default.htm.

Online CPE

AICPA CPExpress, offered exclusively through cpa2biz.com, is AICPA's flagship online learning product. 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 CPExpress offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com/infobytes.

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

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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—2005/06*. 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 and Financial Markets Association	www.sifma.org 120 Broadway, 35th floor New York, NY 10271-0080 Telephone: (212) 608-1500 360 Madison Ave. New York, NY 10017-7111 Telephone: (646) 637-9200

(continued)

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
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