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

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Audit & Accounting Guide: Brokers and Dealers in Securities

July 1, 2010

AUDIT & ACCOUNTING GUIDE

Brokers and Dealers in Securities

JULY 1, 2010

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AUDIT & ACCOUNTING GUIDE

Brokers and Dealers in Securities

WITH CONFORMING CHANGES AS OF

JULY 1, 2010

This edition of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, which was originally issued in 1997, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the guide was originally issued and other changes necessary to keep the guide current on industry and regulatory matters. The schedule of changes identifies all changes made in this edition of the guide. The changes do *not* include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

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Preface

About AICPA Audit and Accounting Guides

This AICPA Audit and Accounting Guide has been developed by the AICPA Stockbrokerage and Investment Banking Committee to assist management in the preparation of their financial statements in conformity with U.S. generally accepted accounting principles (GAAP) and to assist auditors in auditing and reporting on such financial statements.

The financial accounting and reporting guidance contained in this guide, when developed by the original task force or committee, was approved by the affirmative vote of at least two-thirds of the members of the Accounting Standards Executive Committee, now the Financial Reporting Executive Committee (FinREC). FinREC is the senior technical body of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Conforming updates made to the financial accounting and reporting guidance contained in this guide in years subsequent to the original development are reviewed by select FinREC members, among other reviewers where applicable.

This guide does the following:

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

Accounting guidance for nongovernmental entities included in an AICPA Audit and Accounting Guide is a source of nonauthoritative accounting guidance. As discussed later in this preface, FASB ASC is the authoritative source of U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission (SEC). Accounting guidance for governmental entities included in an AICPA Audit and Accounting Guide is a source of authoritative accounting guidance described in category (b) of the hierarchy of GAAP for state and local governmental entities, and has been cleared by the Governmental Accounting Standards Board (GASB). AICPA members should be prepared to justify departures from GAAP as discussed in Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, vol. 2, ET sec. 203 par. .01).

Auditing guidance included in an AICPA Audit and Accounting Guide is recognized as an interpretive publication pursuant to AU section 150, *Generally*

Accepted Auditing Standards (AICPA, *Professional Standards*, vol. 1). Interpretive publications are recommendations on the application of Statements on Auditing Standards (SASs) in specific circumstances, including engagements for entities in specialized industries. An interpretive publication is issued under the authority of the Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with the SASs. The members of the ASB have found this guide to be consistent with existing SASs.

The auditor should be aware of and consider interpretive publications applicable to his or her audit. If an auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.

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The Stockbrokerage and Investment Banking Committee gratefully acknowledges the contributions of former committee chairs Edward H. Jones and Thomas C. Lockburner, and members Victor P. Capadona, Regina A. Dolan, Dennis E. Feeney, Michael Ferman, David C. Fisher, Richard C. Flowers, David Goldfarb, G. Victor Johnson, Marshall J. Levinson, Donald H. MacNeal, Robert B. Mills, Carlos Onis, Victoria A. Pellegrino, Kevin C. Piccoli, Leonard M. Rush, Jonas B. Siegal, Stuart Steckler, Lawrence A. Stoler, Peter W. Testaverde, Jr., and Charles F. Vadala, Jr. The committee also gratefully acknowledges the contributions of Michael Macchiaroli of the SEC and of Paul H. Bjarnason, Jr. of the Commodity Futures Trading Commission.

The committee is grateful to Adrian Fitzsimons, professor, St. John's University, for his assistance in writing the guide.

The AICPA gratefully acknowledges those who reviewed and otherwise contributed to the development of this guide: Jeffrey Alfano, Anthony Anzevino, Michael Fehrman, Albert Goll, Dipti Gulati, Christopher Johnson, Andrew Labadie, Paul Lameo, Jonathan Lee, Hiren Modi, Paul Nockels, Mark Ramler, Khalid Shah, Michael Smith, and Stephen Zammitti.

Guidance Considered in This Guide

This edition of the guide has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative guidance since the guide was originally issued. Authoritative guidance issued through July 1, 2010, has been considered in the development of this edition of the guide. Authoritative guidance discussed in the text of the guide (as differentiated from the temporary footnotes, which are denoted by a symbol rather than a number) is effective for entities with fiscal years ending on or before July 1, 2010. Authoritative guidance discussed only in temporary footnotes is not yet effective as of July 1, 2010, for entities with fiscal years ending after that same date.

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

- Accounting Standards Update (ASU) No. 2010-18, *Receivables (Topic 310): Effect of a Loan Modification When the Loan is Part of a Pool That is Accounted for as a Single Asset—A Consensus of the Emerging Issues Task Force*
- SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 558)
- Revised interpretations issued through July 1, 2010, including interpretation Nos. 1–4 of AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9325 par. .01–.13)
- Statement of Position 09-1, *Performing Agreed-Upon Procedures Engagements That Address the Completeness, Accuracy, or Consistency of XBRL-Tagged Data* (AICPA, *Technical Practice Aids*, AUD sec. 14,440)
- Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, vol. 1, AT sec. 801)
- Interpretation No. 7, "Reporting on the Design of Internal Control," of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 9101 par. .59–.69)

- Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 7, *Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, Standards, AU-P sec. 162)

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

The changes made to this edition of the guide are identified in the schedule of changes in appendix O. The changes do not include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

Applicability of U.S. GAAP and PCAOB Standards

Audits of the financial statements of nonissuers (those entities not subject to the Sarbanes-Oxley Act of 2002 or the rules of the SEC—that is, private entities, generally speaking) are conducted in accordance with U.S. generally accepted auditing standards (GAAS),[*] as issued by the ASB, the senior technical committee of the AICPA, with the authority to promulgate auditing standards for nonissuers. The ASB develops and issues standards in the form of SASs through a due process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. The SASs and their related interpretations are codified in the AICPA's *Professional Standards*. Paragraph .03 of AU section 150 establishes that an AICPA member's failure to follow ASB standards for audits of nonissuers is a violation of Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 202 par. .01), of the AICPA Code of Professional Conduct.

Audits of the financial statements of *issuers*, as defined by the SEC (those entities subject to the Sarbanes-Oxley Act of 2002 or the rules of the SEC—that is, public entities, generally speaking), are conducted in accordance with standards established by the PCAOB, a private sector, nonprofit corporation created by the Sarbanes-Oxley Act of 2002 to oversee the audits of issuers. The SEC has oversight authority over the PCAOB, including the approval of its rules, standards, and budget.

For audits of a nonissuer, in accordance with both GAAS and PCAOB standards, Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report on a Nonissuer," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .89–.92), provides reporting guidance applicable to such engagements.

References to Professional Standards

In citing GAAS and their related interpretations, references use section numbers within the codification of currently effective SASs and not the original statement number, as appropriate. For example, SAS No. 54, *Illegal Acts by Clients*, is referred to as AU section 317, *Illegal Acts by Clients* (AICPA,

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[*] See the following section, "The Dodd-Frank Wall Street Reform and Consumer Protection Act," for recent developments related to the Public Company Accounting Oversight Board's oversight of audits of broker-dealers.

Professional Standards, vol. 1). In those sections of the guides that refer to specific auditing standards of the PCAOB, references are made to the AICPA's *PCAOB Standards and Related Rules* publication.

FASB ASC

Overview

Released on July 1, 2009, FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by topically organizing the authoritative literature. FASB ASC disassembled and reassembled thousands of nongovernmental accounting pronouncements (including those of FASB, the Emerging Issues Task Force, and the AICPA) to organize them under approximately 90 topics.

FASB ASC also includes relevant portions of authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance issued by the SEC; however, FASB ASC is not the official source of SEC guidance and does not contain the entire population of SEC rules, regulations, interpretive releases, and SEC staff guidance. Moreover, FASB ASC does not include governmental accounting standards.

FASB published a Notice to Constituents (NTC) that explains the scope, structure, and usage of consistent terminology of FASB ASC. Constituents are encouraged to read this NTC because it answers many common questions about FASB ASC. FASB ASC, and its related NTC, can be accessed at http://asc.fasb.org/home and are also offered by certain third party licensees, including the AICPA. FASB ASC is offered by FASB at no charge in a "Basic View" and for an annual fee in a "Professional View."

FASB Statement No. 168

In June 2009, FASB issued the last FASB statement referenced in that form: FASB Statement No. 168, *The* FASB Accounting Standards Codification™ *and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*. This standard establishes FASB ASC as the authoritative source of U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC, and is effective for financial statements issued for interim and annual periods ending after September 15, 2009.

This standard flattened the historic U.S. GAAP hierarchy to two levels: one that is authoritative (in FASB ASC) and one that is nonauthoritative (not in FASB ASC). Exceptions include all rules and interpretive releases of the SEC under the authority of federal securities laws, which are sources of authoritative U.S. GAAP for SEC registrants, and certain grandfathered guidance having an effective date before March 15, 1992.

Issuance of New Standards

New standards are now issued by FASB through ASUs and will serve only to update FASB ASC. FASB does not consider the ASUs authoritative in their own right; new standards become authoritative when they are incorporated into FASB ASC.

New standards will be in the form of ASU No. 20YY-XX, in which "YY" is the last two digits of the year and "XX" is the sequential number for each update. For example, ASU No. 2010-01 is the first update in the calendar year 2010. New standards will include the standard and an appendix of FASB ASC update instructions. ASUs will also provide background information about the standards and provide the basis for conclusions on changes made to FASB ASC.

Pending Content in FASB ASC

Any ASUs (or other authoritative accounting guidance issued prior to the release date of FASB ASC) issued but not yet fully effective for all entities or transactions within its scope are reflected as "Pending Content" in FASB ASC. This pending content is shown in text boxes below the paragraphs being amended in FASB ASC and includes links to the transition information. The pending content boxes are meant to provide users with information about how a paragraph will change when new guidance becomes authoritative. When an amended paragraph becomes fully effective, the outdated guidance will be removed, and the amended paragraph will remain without the pending content box. FASB will keep any outdated guidance in the applicable archive section of FASB ASC for historical purposes.

Because not all entities have the same fiscal year-ends, and certain guidance may be effective on different dates for public and nonpublic entities, the pending content will apply to different entities at different times. As such, pending content will remain in place within FASB ASC until the "roll-off" date. Generally, the roll-off date is six months following the latest fiscal year end for which the original guidance being amended or superseded by the pending content could be applied as specified by the transition guidance. For example, assume an ASU has an effective date for fiscal years beginning after November 15, 2009. The latest possible fiscal year end of an entity still eligible to apply the original guidance being amended or superseded by the pending content would begin November 15, 2009, and end November 14, 2010. Accordingly, the roll-off date would be May 14, 2011.

Entities cannot disregard the pending content boxes. Instead, all entities must review the transition guidance to determine if and when the pending content is applicable to them. This audit and accounting guide identifies pending content where applicable. As explained in the "Guidance Considered in This Edition" section of the preface, pending content discussed in the text of the guide (as differentiated from temporary footnotes, which are denoted by a symbol rather than a number) is effective for entities with fiscal years ending on or before July 1, 2010. Pending content discussed only in temporary footnotes is not yet effective as of July 1, 2010, for entities with fiscal years ending after that same date.

New AICPA.org Website

The AICPA encourages you to visit the new website at www.aicpa.org/. It launched in 2010 and provides significantly enhanced functionality and content critical to the success of AICPA members and other constituents. Certain content on the AICPA's website referenced in this guide may be restricted to AICPA members only.

Select Recent Developments Significant to This Guide

The Dodd-Frank Wall Street Reform and Consumer Protection Act

PCAOB Oversight

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) was signed into law by the President on July 21, 2010. The Dodd-Frank Act amends the Sarbanes-Oxley Act of 2002 to give the PCAOB full oversight authority over audits of all broker-dealers (including nonissuers), which includes standard setting, inspection, and enforcement. Although the Dodd-Frank Act gives the PCAOB authority to require a program of inspection for auditors of all broker-dealers, it allows the PCAOB, in its inspection rule, to differentiate among classes of broker-dealers and exempt auditors of a particular class (such as those who do not engage in clearing, carrying, or custody of client assets) from inspection. The Dodd-Frank Act reconciles registration with inspection so that a public accounting firm will not be required to register with the PCAOB if it is exempt from the inspection program. Regarding inspections to be performed, it is anticipated that limited inspections of auditors of broker-dealers may be performed during 2011.

PCAOB oversight includes a provision that audits of nonissuer broker-dealers are to be conducted in accordance with PCAOB auditing standards. However, the SEC has indicated that standards for such audits will need to be developed or amended. Consequently, the SEC has issued transitional guidance in SEC Release No. 34-62991, *Commission Guidance Regarding Auditing, Attestation and Related Professional Practice Standards Related to Brokers and Dealers*, which clarifies that audits of nonissuer broker-dealers will continue to be performed under GAAS and any applicable rules of the SEC. This interpretation will be revisited in connection with the standard setting project mentioned previously.

Sarbanes-Oxley Act of 2002 Section 404(b) Exemption

The Dodd-Frank Act amends the Sarbanes-Oxley Act of 2002 to make permanent the exemption from the auditor attestation requirement of Section 404(b) for nonaccelerated filers (those with less than $75 million in market cap) that has been temporarily in effect by order of the SEC. The Dodd-Frank Act also requires the SEC to complete a study within 9 months of enactment on how to reduce the burden of 404(b) compliance for companies with market caps between $75 million and $250 million. The study will consider whether any such methods of reducing the burden, or a complete exemption, would encourage companies to list on exchanges.

Securities Investor Protection Act Amendments

The Dodd-Frank Act increases the credit line at the U.S. Treasury from $1 billion to $2.5 billion to support the work of the Securities Investor Protection Corporation (SIPC) and raises SIPC's maximum cash advance amount to $250,000 in order to bring the program in line with the protection provided by the Federal Deposit Insurance Corporation.

In addition, the Dodd-Frank Act amended the Securities Investor Protection Act in 2 areas that pertain to the SIPC assessment imposed on members. First, the highest amount that SIPC can impose as a minimum assessment has been

changed from $150 per annum to 2 basis points of a SIPC member's gross revenues from the securities business. In addition, the definition of *gross revenues from the securities business* has been revised to include revenues earned by a member in connection with a transaction in the portfolio margining account of a customer carried as securities accounts pursuant to a portfolio margining program approved by the SEC. See the SIPC website for more information and for the SIPC-7 form, which was revised in July 2010 for the above mentioned amendments.

SEC Developments—Amendment to Rule 206(4)-2

In December 2009, the SEC adopted rules designed to substantially increase the protections for investor funds and securities of which an investment adviser registered with the SEC has custody. Amendments to the rules under the Investment Advisers Act of 1940 revise an existing surprise examination requirement, and introduces an internal control examination requirement. The effective date of the amendment is March 12, 2010, subject to certain exceptions. For complete information see SEC Release No. IA-2968, *Custody of Funds or Securities of Clients by Investment Advisers*, and the related Interpretive Release No. IA-2969, *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*.[†] Additionally, the SEC has released frequently asked questions about the custody rule, which can be located at www.sec.gov/divisions/investment/custody_faq_030510.htm.[‡]

Withdrawal of GAAP Hierarchies From the Auditing Standards

In response to the issuance of recent pronouncements by FASB, GASB, and the Federal Accounting Standards Advisory Board to incorporate their respective GAAP hierarchies into their respective authoritative literature, the ASB has withdrawn SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*, from the auditing literature effective September 2009. Similarly, with the release of PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Standards, AU-P sec. 420), and conforming amendments in January 2008, the PCAOB also removed the GAAP hierarchy from its interim auditing standards applicable to issuers.

ASB's Clarity Project

In an effort to make GAAS easier to read, understand, and apply, the ASB launched the Clarity Project. When completed, clarified auditing standards will be issued as one SAS that will supersede all prior SASs. The new audit standards are expected to apply to audits of financial statements for periods ending on or after December 15, 2012.

The foundation of the ASB's Clarity Project is the establishment of an objective for each auditing standard. These objectives will better reflect a

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[†] SEC release No. IA-2968, *Custody of Funds or Securities of Clients by Investment Advisers*, is available on the SEC website at http://sec.gov/rules/final/2009/ia-2968.pdf. SEC release No. IA-2969, *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*, is available at http://sec.gov/rules/interp/2009/ia-2969.pdf.

[‡] See chapter 3, "Regulatory Considerations," of this guide for a discussion of the amendments.

principles-based approach to standard-setting. In addition to having objectives, the clarified standards will reflect new drafting conventions that include

- adding a definitions section, if relevant, in each standard.
- separating requirements from application and other explanatory material.
- numbering application and other explanatory material paragraphs using an *A* prefix and presenting them in a separate section (following the requirements section).
- using formatting techniques, such as bulleted lists, to enhance readability.
- adding special considerations relevant to audits of smaller, less complex entities.
- adding special considerations relevant to audits of governmental entities.

The project also has an international convergence component. The ASB expects that, upon completion of the project, nearly all the requirements of International Standards on Auditing will also be requirements of U.S. GAAS. AICPA Audit and Accounting Guides, as well as other AICPA publications, will be conformed to reflect the new standards resulting from the Clarity Project after issuance and as appropriate based on the effective dates.

International Financial Reporting Standards

International Financial Reporting Standards (IFRSs) consist of accounting standards and interpretations developed and issued by the International Accounting Standards Board (IASB), a London-based independent accounting standard-setting body. IASB began operations in 2001, when it succeeded the International Accounting Standards Committee (IASC). IASC was formed in 1973, soon after the formation of FASB. In 2001, when the IASB replaced the IASC, a new, independent oversight body, the IASC Foundation, was created to appoint the members of the IASB and oversee its due process. The IASC Foundation's oversight role is very similar to that of the Financial Accounting Foundation in its capacity as the oversight body of FASB.

The term *IFRSs* has both a narrow and a broad meaning. Narrowly, IFRSs refer to the new numbered series of pronouncements issued by the IASB, as differentiated from International Accounting Standards (IASs) issued by its predecessor, the IASC. More broadly, however, IFRSs refer to the entire body of authoritative IASB pronouncements, including those issued by the IASC and their respective interpretive bodies. Therefore, the authoritative IFRS literature, in its broadest sense, includes the following:

- Standards, whether labeled IFRSs or IASs
- Interpretations, whether labeled IFRIC (referring to the International Financial Reporting Interpretations Committee, the current interpretive body of the IASC Foundation) or SIC (Standing Interpretations Committee, the predecessor to IFRIC and former interpretive body of the IASC)
- IFRS framework

As of March 31, 2010, IFRIC formally changed its name to the IFRS Interpretations Committee and on July 1, 2010, the IASC Foundation formally changed its name to the IFRS Foundation.

The preface to the *IFRS 2009* bound volume states that IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities including commercial, industrial, and financial entities regardless of legal form or organization. Included within the scope of profit-oriented entities are mutual insurance companies and other mutual cooperative entities providing dividends or other economic benefits to their owners, members, or participants.

IFRSs are not designed to apply to not-for-profit entities or those in the public sector, but these entities may find IFRSs appropriate in accounting for their activities. In contrast, U.S. GAAP is designed to apply to all nongovernmental entities, including not-for-profit entities, and includes specific guidance for not-for-profit entities, development stage entities, limited liability entities, and personal financial statements.

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

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

Purpose and Applicability

This AICPA Audit and Accounting Guide has been prepared to assist broker-dealers in preparing financial statements in conformity with U.S. GAAP and to assist independent accountants in reporting on financial statements (and other written management assertions) of those entities.

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

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

Members of the Financial Industry Regulatory Authority are subject to the rules of that organization, and members of securities exchanges are also subject to the rules of the exchanges of which they are members. Some of these rules, as currently in effect, are discussed in this guide. However, the rules, regulations, practices, and procedures of the securities and commodities futures industries have changed frequently and extensively in recent years. Still, further changes are under consideration as this guide goes to press, and the auditor should keep abreast of these changes.

Limitations

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

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

Applicability of Requirements of the Sarbanes-Oxley Act of 2002

Publicly held companies and other issuers (see definition, which follows) are subject to the provisions of the Sarbanes-Oxley Act of 2002 and related SEC regulations implementing the act. Their outside auditors are also subject to the provisions of the act and to the rules and standards issued by the PCAOB.

Section 205(c)(2) of the act amended Section 17 (*Commerce and Trade*, U.S. Code [USC] Title 15 Section 78q) of the Securities Exchange Act of 1934 to require all broker-dealers (both issuer and nonissuer) to be audited by a public accounting firm registered with the PCAOB. For fiscal years ending after December 31, 2008, the financial statements of nonissuer broker-dealers must be certified by a public accounting firm that is registered with the PCAOB.

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

Definition of an Issuer

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

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

Nonissuers are those entities not subject to the act or the rules of the SEC.

Guidance for Issuers

Management Assessment of Internal Control

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

As established by Rule 12b-2 of the Exchange Act, the auditor's attestation requirement for large accelerated and accelerated filers is currently effective. The Dodd-Frank Act amended Section 404 of the Sarbanes-Oxley Act of 2002 to permanently exclude nonaccelerated filers from the auditor attestation requirement of Section 404(b).

Guidance for Auditors of Issuer Broker-Dealers

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

Guidance for Nonissuer Broker-Dealers

Pursuant to the exchange act, the SEC developed a comprehensive system to regulate broker-dealers, and the securities industry in general. As a result, broker-dealers, including nonissuer broker-dealers, are subject to regulation by the SEC. Although this guide is directed toward nonissuer broker-dealers, it does contain some content regarding audits of issuer broker-dealers.

Guidance for Auditors of Nonissuer Broker-Dealers

As mentioned previously, auditors of nonissuer broker-dealers are required to be registered with the PCAOB in order to certify the financial statements of a broker-dealer for fiscal years ending after December 31, 2008. However, although issuer broker-dealers are required to be audited under PCAOB auditing standards, nonissuer broker-dealers are not. A PCAOB registered auditor of a nonissuer broker-dealer currently performs the audit under GAAS. (See the section, "The Dodd-Frank Wall Street Reform and Consumer Protection Act," for recent developments in this area.)

TABLE OF CONTENTS

Chapter		Paragraph
1	The Securities Industry	.01-.120
	Brokers and Dealers	.04-.17
	Discount Brokers	.06
	Investment Bankers	.07-.09
	Government Securities Dealers	.10
	Specialists	.11
	Clearing Brokers	.12
	Carrying Brokers	.13
	Prime Brokers	.14
	Introducing Brokers	.15
	Brokers' Brokers	.16
	Bank-Owned Brokers (Section 4k4[e] and Section 20 Brokers)	.17
	The Financial Markets	.18-.33
	Exchange Market	.21-.24
	OTC Market	.25-.29
	Third Market	.30
	Alternative Trading Venues	.31-.33
	Clearing Organizations and Depositories	.34-.39
	Transfer Agents	.40-.43
	Regulatory Overview	.44-.47
	Business Activities	.48-.120
	Brokerage	.48-.56
	Firm Trading	.57-.91
	Investment Banking	.92-.99
	Financing	.100-.112
	Other Activities	.113-.120
2	Broker-Dealer Functions, Books, and Records	.01-.170
	Introduction	.01-.17
	Overview	.01-.03
	Original Entry Journals	.04-.06
	General Ledger	.07
	Stock Record	.08-.12
	Regulatory Recordkeeping Requirements	.13-.14
	Trade Date and Settlement Date	.15-.17
	Trade Execution	.18-.56
	Customer Trades	.18-.45
	Proprietary Trades	.46-.56

Chapter		Paragraph
2	Broker-Dealer Functions, Books, and Records—continued	
	Clearance and Settlement	.57-.86
	Overview	.57-.61
	Comparison	.62-.66
	Settlement	.67-.83
	Bookkeeping	.84-.86
	Specialized Clearance Activities	.87-.114
	Mortgage-Backed Securities	.87-.91
	Government Securities	.92-.94
	Repos and Reverse Repos	.95-.96
	Derivative Securities	.97-.99
	Commodity Futures and Options on Futures	.100-.104
	Forward Transactions	.105
	Municipal Securities	.106-.107
	International Securities	.108
	Options on Securities	.109-.114
	Reconciliation and Balancing	.115-.118
	Custody	.119-.129
	Possession or Control	.120-.123
	Securities Transfer	.124-.129
	Dividends, Interest, and Reorganization	.130-.143
	Dividends and Interest	.130-.138
	Reorganization	.139-.143
	Collateralized Financing	.144-.157
	Stock Loan and Stock Borrow	.144-.147
	Bank Loan Financing	.148-.151
	Reverse Repos and Repos	.152-.157
	Regulatory	.158-.165
	Tax Information Reporting	.166-.169
	Illustrative Stock Record Entries	.170
3	Regulatory Considerations	.01-.149
	Applicable Rules	.02-.05
	Interpretations of Rules	.04-.05
	Explanation of Significant SEC Financial Responsibility Rules	.06-.94
	SEC Rule 15c3-3, "Customer Protection: Reserves and Custody of Securities"	.06-.36
	SEC Rule 15c3-1, "The Uniform Net Capital Rule"	.37-.54
	SEC Rule 17a-13, "Quarterly Security Counts"	.55-.57
	SEC Rule 17a-3, "Records to Be Made by Broker-Dealers"	.58

Chapter		Paragraph
3	Regulatory Considerations—continued	
	SEC Rule 17a-4, "Records to Be Preserved by Broker-Dealers"	.59
	Regulation T and Maintenance Margin	.60-.66
	SEC and CFTC Rules Governing Customer Margin for Transactions in Security Futures	.67
	SEC Rules 17h-1T and 17h-2T, "Final Temporary Risk Assessment Rules"	.68-.71
	SEC Rule 17a-5, "Reports to Be Made by Certain Brokers and Dealers"	.72-.91
	Antimoney Laundering Regulations	.92-.94
	Reporting Requirements	.95-.118
	Consolidation of Subsidiaries	.100
	The Annual Audited Report	.101-.118
	Filings Concurrent With the Annual Audited Report	.119-.130
	Report on Internal Control Required by SEC Rule 17a-5	.119-.123
	Report to State Regulatory Agencies	.124
	Financial Statements to Be Furnished to Customers of Securities Broker-Dealers	.125-.130
	Other Reports	.131-.134
	Reports on Securities Investor Protection Corporation Assessment	.131-.133
	Reports on Agreed-Upon Procedures for Distributions	.134
	Additional Requirements for Registered Investment Advisers	.135-.143
	Rules Applicable to Broker-Dealers in Commodities and U.S. Government Securities	.144-.146
	Commodities FCMs	.145
	Government Securities Broker-Dealers	.146
	OTC Derivatives Dealers	.147-.148
	Annual Compliance Certification	.149
4	Financial Statement Presentation and Classification	.01-.95
	Introduction	.01-.05
	Financial Statements	.06-.17
	Statement of Financial Condition	.06-.09
	Statement of Income or Operations	.10
	Statement of Cash Flows	.11-.12
	Statement of Changes in Ownership Equity	.13-.14
	Statement of Changes in Liabilities Subordinated to Claims of General Creditors	.15
	Consolidation of Subsidiaries	.16-.17
	Supplementary Schedules	.18-.22
	Computation of Net Capital Pursuant to SEC Rule 15c3-1	.19

Chapter Paragraph

4 Financial Statement Presentation and Classification—continued
Computation for Determination of Reserve Requirements Pursuant to Rule 15c3-3 .... .20
Information Relating to Possession or Control Requirements Under Rule 15c3-3 .... .21
Schedules of Segregation Requirements and Funds in Segregation Pursuant to the Commodity Exchange Act .... .22
Statement of Financial Condition Account Descriptions .... .23-.59
Cash .... .24
Memberships in Exchanges .... .25
Receivables From and Payables to Broker-Dealers and Clearing Organizations .... .27-.41
Receivables From and Payables to Customers .... .42
Securities Sold Under Agreements to Repurchase .... .43
Securities Purchased Under Agreements to Resell .... .44
Securities Owned and Securities Sold, Not Yet Purchased .45-.50
Bank Loans .... .51-.53
Commitments, Contingencies, and Guarantees .... .54
Subordinated Borrowings .... .55-.59
Income Statement Account Descriptions .... .60-.74
Commission Income .... .61-.62
Interest Income and Expense .... .63-.64
Dividend Income and Expense .... .65
Trading Gains and Losses (Principal Transactions) .... .66
Underwriting Income or Loss .... .67
Management and Investment Advisory Income .... .68
Floor Brokerage .... .69
Exchange Fees .... .70
Occupancy .... .71
Employee Compensation and Benefits .... .72-.73
Communications and Data Processing .... .74
Disclosures .... .75-.88
Disclosures of Certain Significant Risks and Uncertainties .... .75-.84
Disclosures About Derivative Instruments .... .85-.88
Guarantees .... .89-.90
Subsequent Events .... .91-.92
Financial Statements and Schedules .... .93-.95

5 Auditing Considerations .01-.194
General Considerations .... .01-.02
Auditor Requirements .... .03-.05
Regulatory Environment .... .06-.14

Chapter Paragraph

5 Auditing Considerations—continued
Planning and Other Auditing Considerations .... .15-.32
Audit Planning .... .16-.17
Establishing an Understanding With the Client .... .18-.19
Audit Risks .... .20-.25
Planning Materiality .... .26-.30
Illegal Acts .... .31-.32
Use of Assertions in Obtaining Audit Evidence .... .33-.34
Understanding the Entity, Its Environment, and Its Internal Control .... .35-.44
Risk Assessment Procedures .... .38-.39
Discussion Among the Audit Team .... .40
Understanding of the Entity and Its Environment .... .41-.42
Understanding of Internal Control .... .43-.44
Assessment of Risks of Material Misstatement and the Design of Further Audit Procedures .... .45-.64
Assessing the Risks of Material Misstatement .... .46-.48
Designing and Performing Further Audit Procedures .... .49-.64
Evaluating Misstatements .... .65-.66
Audit Documentation .... .67-.76
Audits Conducted in Accordance With GAAS .... .67-.73
Audits Conducted in Accordance With PCAOB Standards .... .74-.76
Consideration of Fraud in a Financial Statement Audit .... .77-.100
The Importance of Exercising Professional Skepticism .... .80
Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud .... .81-.82
Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud .... .83-.86
Identifying Risks That May Result in a Material Misstatement Due to Fraud .... .87-.90
Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks .... .91-.92
Responding to the Results of the Assessment .... .93
Evaluating Audit Evidence .... .94-.95
Responding to Misstatements That May Be the Result of Fraud .... .96-.98
Communicating About Possible Fraud to Management, Those Charged With Governance, and Others .... .99
Documenting the Auditor's Consideration of Fraud .... .100
Consideration of the Work of Internal Auditors .... .101-.103
Analytical Procedures .... .104-.112

Chapter Paragraph

5 Auditing Considerations—continued
Auditing Accounting Estimates .113-.118
Audits Conducted in Accordance With GAAS .118
Going-Concern Considerations .119-.121
Communication of Matters Related to Internal Control .122-.128
Audits Conducted in Accordance With GAAS .122-.124
Audits Conducted in Accordance With PCAOB Standards .125-.128
Communication With Those Charged With Governance .129
Management Representations .130-.133
Effect of Information Technology on Internal Control .134-.138
Consideration of Controls at IT Service Centers .139-.146
Omnibus and Fully Disclosed Accounts .147-.152
Omnibus Accounts .148-.149
Fully Disclosed Accounts .150-.152
Substantive Audit Procedures .153-.188
Stock Record .154-.155
Securities in Physical Possession .156-.160
Securities in for Transfer, Exchange, or Redemption .161-.162
Securities Serviced at Depositories .163-.164
Securities Failed to Receive and Failed to Deliver, Securities Borrowed and Loaned, Securities Held Under Repos and Reverse Repos, and Securities Held as Collateral for Bank Loans .165
Securities Held by Branch Office .166
Securities Position Differences .167
Customers' Accounts (Including Partners, Officers, Directors, Employees, and Shareholders) .168-.170
Trading and Investment Accounts .171-.175
Good-Faith Deposits .176
Subordinated Accounts and Borrowings .177
Dividends Receivable or Payable .178
Unclaimed Dividends, Coupons, and Securities .179
Exchange Memberships .180
Open Contractual Commitments .181-.184
Private Placements .185
Mutual Funds .186
Municipal Refunding Bond Underwritings .187
Suspense Accounts .188
Computation of Formula for Determination of Reserve Requirement, Possession or Control of Securities, and Net Capital .189-.193

Chapter Paragraph

5 Auditing Considerations—continued
Reserve Requirement and Possession or Control of Securities .... .189-.191
Net Capital .... .192-.193
Appendix A—Securities Broker-Dealers' Auditing Considerations .... .194

6 Internal Control .01-.74
Auditor's Understanding of Internal Control in a Financial Statement Audit .... .01-.07
The Control Environment .... .08-.13
Understanding the Control Environment .... .11-.13
Risk Assessment for Financial Reporting Purposes .... .14-.24
Understanding Risk Assessment .... .23-.24
Information and Communication System .... .25-.26
Understanding the Broker-Dealer's Information and Communication System .... .27-.30
Control Activities .... .31-.39
Understanding Control Activities .... .33-.39
Monitoring .... .40-.45
Understanding Monitoring Activities .... .45
Broker-Dealer Control and Monitoring Activities .... .46-.67
Sales and Compliance .... .49-.52
Clearance .... .53-.54
Securities Settlement .... .55-.56
Custody .... .57-.58
Dividends, Interest, and Reorganization .... .59-.60
Mortgage-Backed Securities .... .61
Principal Transactions .... .62-.63
OTC-Derivative Transactions .... .64
Collateralized Financings .... .65-.67
Report on Internal Control Required by SEC Rule 17a-5(g)(1) .... .68
SEC Requirements for Management's Report on Internal Control Over Financial Reporting .... .69-.74
Annual Reporting Requirements .... .71
Quarterly Reporting Requirements .... .72-.74

7 Accounting Standards .01-.117
Accounting Model .... .02-.34
Definition of Fair Value .... .06-.08
Application to Assets .... .09-.10
Application to Liabilities .... .11

Chapter Paragraph

7 Accounting Standards—continued
Valuation Techniques .... .12-.14
Present Value Techniques .... .15-.18
The Fair Value Hierarchy .... .19-.24
Fair Value Determination When the Volume or Level of Activity Has Significantly Decreased .... .25-.29
Disclosures .... .30-.31
Fair Value Option .... .32-.34
Additional Fair Value Considerations .... .35-.49
Financial Instruments Listed on a Recognized Exchange .... .35-.39
Financial Instruments Not Listed on a Recognized Exchange but Having a Readily Available Market Price .... .40-.43
Financial Instruments Not Having a Readily Available Market Price .... .44-.49
Trade-Date Versus Settlement-Date Accounting .... .50-.63
Proprietary/Principal Transactions .... .53-.60
Agency Transactions .... .61-.63
Statement-of-Financial-Condition Considerations .... .64-.100
Due From and Due to Other Broker-Dealers and Clearing Entities .... .64-.65
Secured Borrowings .... .66-.74
Exchange Memberships Owned or Contributed .... .75
Suspense Accounts .... .76
Conditional Transactions .... .77
Leveraged Buyouts and Bridge Loans .... .78
Asset Securitizations .... .79-.82
Variable Interest Entities .... .83
Derivatives .... .84-.93
Soft-Dollar Arrangements .... .94-.97
Mandatorily Redeemable Instruments .... .98-.100
Statement-of-Income/Loss Considerations .... .101-.113
Underwriting Revenues and Expenses .... .101-.105
Mutual Fund Distribution Costs .... .106-.108
Half-Turn Convention .... .109
Interest, Dividends, and Rebates .... .110-.112
Costs Associated With Exit or Disposal Activities .... .113

Appendixes

A Auditor's Standard Report
B Separate Report on Supplementary Schedules
C Report on Internal Control Required by SEC Rule 17a-5(g)(1)

Appendixes

D Report on Internal Control Required by SEC Rule 17a-5(g)(1) for a Broker-Dealer Claiming an Exemption From SEC Rule 15c3-3

E Letter to SEC When the Broker-Dealer Has Not Made the Required Notification

F Report on Internal Control Required by CFTC Regulation 1.16 and SEC Rule 17a-5(g)(1)

G Independent Accountants' Report on Applying Agreed-Upon Procedures Related to an Entity's SIPC Assessment Reconciliation

H Representation Letter

I Agreed-Upon Procedures

J Agency Issues Participation Listing

K Confirmation Statistics

L List of Reallowance Orders

M Information Sources

N International Financial Reporting Standards

O Schedule of Changes Made to the Text From the Previous Edition

Glossary

Chapter 1

The Securities Industry

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

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

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

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

Brokers and Dealers

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

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

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

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

Discount Brokers

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

Investment Bankers

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

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

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

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

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

Government Securities Dealers

1.10 *U.S. government securities dealers* are a group of dealer firms that underwrite and trade U.S. government and federal agency securities. Certain of these firms are designated by the Federal Reserve Bank of New York as primary dealers in U.S. government securities, and they deal directly with U.S. government fiscal agents (the Federal Reserve Banks) in acquiring new securities issues. These dealers make a market in most U.S. government and federal agency securities and, as such, quote bid and asked prices. In addition to complying with the rules and regulations promulgated by the SEC pursuant to the Federal Securities Laws, these broker-dealers are also subject to certain rules and regulations of the Department of the Treasury. See paragraph 3.146 for specific rule provisions relating to Government Securities Dealers.

Specialists

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

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

Clearing Brokers

1.12 A *clearing broker* is a broker-dealer who receives and executes customers' instructions, prepares trade confirmations, settles the money related to the trades, arranges for the book entry (or physical movement) of the securities, and shares responsibility with the introducing brokers for compliance with regulatory requirements. See paragraph 1.38 for a discussion of the delivery of securities.

Carrying Brokers

1.13 A *carrying broker* is a broker-dealer that holds customer accounts for introducing broker-dealers. Typically, this type of firm is also a clearing firm for those introducing firms. A carrying broker-dealer is responsible for performing the customer reserve computation and possession and control requirements of SEC Rule 15c3-3. A carrying broker-dealer may carry customer accounts on an omnibus or fully-disclosed basis. See paragraphs 5.147–.152 for a discussion of omnibus and fully disclosed accounts.

Prime Brokers

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

Introducing Brokers

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

Brokers' Brokers

1.16 A *brokers' broker* is a broker-dealer firm that acts as an agent for an undisclosed principal (another broker-dealer) for the purchase and sale of

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

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

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

The Financial Markets

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

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

have less credit risk than equivalent long-term securities, and trade in large denominations.

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

Exchange Market[1]

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

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

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

1.24 With the advent of advanced electronic switching capabilities, certain exchanges have provided their members with the facility of direct order entry to floor specialists. For example, the New York Stock Exchange (NYSE) XPress Orders system provides for an immediate execution of block orders greater than 15,000 shares whenever a quote is in place for at least 15 seconds. Another NYSE system, Super Display Book System, enables member firms to entitle

[1] Regulation National Market System (NMS) contains four interrelated initiatives designed to modernize the regulatory structure of the national market system for U.S. equity markets. The substantive topics addressed by Regulation NMS are (1) order protection, (2) intermarket access, (3) subpenny pricing, and (4) market data. In addition, Regulation NMS updates the existing Securities Exchange Act of 1934 rules governing the national market system, and consolidates them into a single regulation. Regulation NMS included two amendments to the joint industry plans for disseminating market information. See Securities and Exchange Commission Release No. 34-51808 (and related rulings) for more information.

their institutional customers to route orders directly to the NYSE for electronic execution.

OTC Market

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

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

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

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

1.29 Firm price quotations for OTC equity securities are available from the inter-dealer quotation systems of FINRA's OTC Bulletin Board and Pink OTC Markets' Pink Quote.

Third Market

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

Alternative Trading Venues

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

1.32 An electronic communication network (ECN) is an electronic system that brings buyers and sellers together for the electronic execution of

trades. Those who subscribe to ECNs, (generally institutional investors, broker-dealers, and market-makers) can place trades directly on the ECN, typically using limit orders. ECNs post orders on their system for other subscribers to view. The ECN will then automatically match orders for execution. If a subscriber wants to buy a stock through an ECN, but there are no sell orders to match the buy order, the order cannot be executed until a matching sell order comes in. If the order is placed through an ECN during regular trading hours, an ECN that cannot find a match may send the order to another market center for execution.

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

Clearing Organizations and Depositories

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

1.35 The exchange markets have sponsored central clearing agencies, known as *clearing organizations*, to assist in the comparison, clearance, and settlement functions. Deliveries and receipts of securities and the related cash settlements are made through these clearing organizations for broker-dealers. The National Securities Clearing Corporation (NSCC), a subsidiary of the Depository Trust & Clearing Corporation (DTCC), is a large U.S. clearing organization. The Stock Clearing Corporation of Philadelphia (acquired by NASDAQ OMX Group, Inc., in 2008), and the Midwest Clearing Corporation (part of CHX Holdings, Inc.) also facilitate the settlement of securities transactions. In the OTC market, clearance may be accomplished by a variety of methods, including the buying and selling of broker-dealers' exchange-of-trade tickets directly with one another or through a clearing organization. Introducing broker-dealers operating through clearing brokers settle their transactions through those clearing brokers, which in turn settle the transactions through the clearing organizations. The Options Clearing Corporation and the clearing organizations of the commodity exchanges perform similar functions for options and futures trading. Clearance of securities traded on international markets is accomplished in a variety of ways ranging from centralized clearing organizations to corporations whose securities are cleared by major banking organizations.

1.36 Most U.S. government and agency security transactions clear through the use of the book entry safekeeping system maintained by the Federal Reserve Bank of New York. The 12 district Federal Reserve Banks operate a securities

transfer system that permits these securities to be transferred between the book entry safekeeping accounts.

1.37 Settlement of securities transactions can be complex, especially when there is a large volume of transactions in many securities. To avoid duplicated receipt and delivery of securities, the NSCC uses an electronic netting system known as continuous net settlement (CNS). In CNS, a broker-dealer's purchases and sales in the same security are netted, thus leaving the broker-dealer with one daily net settlement obligation per security. The broker-dealer then settles that obligation with the clearing organization. Unique to CNS, the clearing agency interposes itself between the trading broker-dealers on each trade and guarantees the settlement obligations of each broker-dealer's counter trading party. Thus, the broker-dealer's settlement is with the clearing organization, not with the other broker-dealer. Other clearing mechanisms may or may not guarantee settlement. A broker-dealer can settle each day or carry open commitments forward to net against the next day's settlement (hence the continuous nature of CNS).

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

1.39 Some of the major depositories for equities, corporate debt securities, certain eligible mortgage-backed securities, and municipal debt securities are the DTCC and its subsidiaries and the Midwest Securities Trust Company (part of CHX Holdings, Inc.).

Transfer Agents

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

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

1.42 For mutual funds, transfer agents enter the amount of securities purchased by a shareholder on the issuer's books and redeem (liquidate) shares

upon receipt of the customer's written or wire request. Transfer agents, as part of their transfer function, maintain records of the name and address of each security holder, the amount of securities owned by each security holder, the certificate numbers corresponding to a security holder's position, the issue date of the security certificate, and the cancellation date of the security certificate. Many transfer agents also act as paying agents for cash dividends and the distribution of stock dividends and stock splits.

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

Regulatory Overview

1.44 Regulatory environments differ from country to country, and the freedom of entry into the marketplace likewise varies depending on the local regulation. In the United States, the Securities Exchange Act of 1934 provides for the regulation of securities transactions after the securities are initially distributed to public investors in an underwriting. The Securities Exchange Act of 1934 established the SEC, which, among other things, is authorized to promulgate and enforce rules governing the regulation of broker-dealers in securities. The SEC developed, pursuant to the Securities Exchange Act of 1934, a comprehensive system to regulate broker-dealers. Under the Securities Exchange Act of 1934, all broker-dealers are required to be members of self-regulatory organizations, such as FINRA,[2] which performs routine surveillance and monitoring of its members. A similar regulatory framework was established for commodity broker-dealers under the Commodity Futures Trading Commission Act of 1974, which established the Commodity Futures Trading Commission (CFTC) and gave it exclusive jurisdiction over commodity futures matters. The Commodity Futures Modernization Act of 2000 (CFMA) authorized joint regulation by the CFTC and the SEC of security futures products on individual equity issues and on narrow-based indices of securities. The CFMA created a flexible structure for the regulation of futures trading, codified an agreement between the CTFC and the SEC to repeal the ban on trading single-stock futures, and provided legal certainty for OTC derivatives markets. The CFMA amended the definition of *security* in the Securities Act of 1933 and the definitions of *security* and *equity security* in the Securities Exchange Act of 1934 to include a security future. In April 2002, the SEC amended the definition of *equity security* in rules under the Securities Act of 1933 and the Securities Exchange Act of 1934 to conform them to the statutory definitions with respect to security futures.

1.45 Since 1934, the Securities Exchange Act of 1934 has been amended to include virtually all participants in the securities markets and an ever-increasing range of securities-related activities. Originally, the scope of the Securities Exchange Act of 1934 was limited to the regulation of exchanges,

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[2] Financial Industry Regulatory Authority was created in July 2007 through the consolidation of National Association of Securities Dealers and the member regulation, enforcement, and arbitration functions of the New York Stock Exchange. It is the largest nongovernmental regulator for all securities firms doing business in the United States.

members of exchanges, and trading in securities listed on exchanges. The Maloney Act of 1938 amended the Securities Exchange Act of 1934 to cover the OTC markets. The Maloney Act established the National Association of Securities Dealers (now FINRA),[3] which is a self-regulatory organization that has responsibility for oversight of the OTC securities markets.

1.46 In 1975, the Securities Exchange Act of 1934 was amended to extend the authority of the SEC to include securities transfer agents, clearing organizations, and securities depositories. This amendment also established the Municipal Securities Rulemaking Board, which was authorized to prescribe rules regulating the activities of municipal securities broker-dealers. In 1986, the Securities Exchange Act of 1934 was amended by the Government Securities Act of 1986 to require U.S. government securities broker-dealers to register with the SEC. Under the Government Securities Act of 1986, the SEC has the authority to enforce rules promulgated by the Department of the Treasury that concern U.S. government securities broker-dealers. Thus, the Securities Exchange Act of 1934 today provides a comprehensive scheme of regulation for virtually all broker-dealers in securities, the exchanges, and the OTC markets, as well as the facilities for clearing and settling transactions among broker-dealers, depositories, transfer agents, and registrars.

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

Business Activities

Brokerage

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

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[3] See footnote 2.

[*] Prior to 2009, the amount of a member's yearly assessment was the regulatory minimum assessment of $150. However, in March 2009, it was determined that it was reasonably likely that the Securities Investors Protection Corporation (SIPC) fund balance would aggregate less than 1 billion dollars for a period of 6 months or more. Therefore, commencing on April 1, 2009, each SIPC member's assessment rate is 1 quarter of 1 percent of each member's SIPC net operating revenues. This assessment will continue until SIPC provides otherwise. For more information, see the discussion beginning at paragraph 3.131. See the preface of this guide for information on recent developments related to SIPC as a result of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

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

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

1.51 If a customer sells securities, the customer must promptly deliver the certificates to the broker-dealer. Either the proceeds of a sale will be credited to the customer's account on the settlement date or, if requested, a check will be mailed to the customer. In general, under SEC Rule 15c3-3, if the broker-dealer does not receive the securities sold within 10 business days of the settlement date, the broker-dealer is required to close the transaction with the customer by purchasing securities of like kind and quantity. Again, the broker-dealer will hold the customer responsible for any resulting loss.

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

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

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

1.55 *Accounts carried for other brokers*. Clearing brokers maintain the customer accounts of introducing brokers. Fully disclosed accounts are accounts of the introducing broker's customers that are carried on the books of a clearing broker. In a fully disclosed account, the introducing broker's customers are treated as if they were the clearing broker's own customers, except that correspondence to customers usually refers to the introducing broker by including

a phrase such as, "through the courtesy of [*the introducing broker's name*]." The clearing broker maintains the customers' accounts and is usually responsible for collecting the purchase price, the commission, and other fees from the customers. However, the introducing broker generally indemnifies the clearing broker for uncollected amounts from any resulting unsecured accounts of the introducing broker's customers. The clearing broker and the introducing broker enter into a contract that describes the distribution of commissions between brokers.

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

Firm Trading

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

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

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

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

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

1.62 *When-issued transactions*. When-issued transactions are contracts to purchase or sell securities only when, as, and if new securities are issued. Broker-dealers enter into such purchase or sale transactions on pending issues of new securities. Trading in when-issued securities normally begins when the U.S. Treasury, a municipality, state, or some other issuer of securities announces a forthcoming issue. Such transactions are contingent upon the issuance of the securities. Because the exact price and terms of the securities are unknown before the issuance date, trading prior to that date is on a yield basis, that is, based on the yields that buyers expect. The exact terms and price of the security become known on the issuance date, and when-issued trading continues until settlement date, at which time the securities are delivered and the issuer is paid. When-issued transactions may also arise as a result of underwritings, exchanges, and mergers after preliminary agreement to issue the securities is established but before a date for settlement has been set.

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

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

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

1.66 *Futures and forward contracts*. Futures contracts are standardized contracts, traded on organized exchanges, to purchase or sell a specified financial instrument or commodity on a future date at a specified price. Financial futures include contracts for debt instruments (interest rate futures), foreign currencies, and stock indexes. Forward contracts are individually negotiated and have economic characteristics similar to those of futures contracts, but they

are not traded on an organized exchange and, consequently, they are generally referred to as OTC. Forward contracts are contracts for forward placement or delayed delivery of financial instruments or commodities in which one party agrees to buy, and another to sell, a specified security or commodity at a specified price for future delivery.

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

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

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

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

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

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

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

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

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

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

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

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

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

1.80 The typical interest rate swap is an agreement between two parties under which each party agrees to pay the other specified or determinable cash amounts on specified future dates. The cash amounts to be paid by each party

are defined in terms of applying a specified interest rate (either fixed or variable) to a hypothetical principal amount, referred to as the notional principal amount. The interest rate swap does not modify preexisting debt instruments, and no securities actually change hands between the parties.

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

1.82 The term *currency swap* is also used to describe arrangements in which spot and forward foreign exchange contracts are entered into with the same counterparty (foreign exchange swap). The forward amount exchanged is different from the spot amount because the forward amount includes an interest differential between a fixed rate in one currency and a fixed rate in the other currency. Unlike the currency swaps described in the preceding paragraph, in which there is a series of forward exchanges (interest flows), a foreign exchange swap has only one forward exchange.

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

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

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

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

Credit enhancement can take the form of letters of credit, third-party guarantees, liquidity facilities, spread accounts, reserve funds, subordinate interests, and overcollateralization.

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

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

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

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

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

Investment Banking

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

1.93 *Public offerings*. Corporations and governmental entities that desire to raise funds through the public sale of securities normally engage securities broker-dealers to underwrite their securities issues. Underwriting is the act of distributing a new issue of securities (primary offering) or a large block of issued securities (secondary offering). Underwritings are accomplished on either a firm-commitment or a best-efforts basis. The underwriting group for a transaction on a firm-commitment basis agrees to buy the entire security issue

from the issuer for a specified price, with the intent to resell the securities to the public at a slightly higher price. The underwriting group for a best-efforts underwriting agrees to sell the issue at a price to be determined, normally with a minimum requirement to complete the underwriting. An underwriting group may also be formed on a standby basis, in which there is a commitment to buy the securities if called on.

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

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

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

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

1.98 *Private placements*. Broker-dealers may also arrange the private placement of securities by issuers. Private placements are usually conducted on a best-efforts, agency basis and therefore expose the placement agent to less risk than that associated with the underwriting liability of a public offering. Private placements are distributions of securities that do not involve public offerings. Typically, private placements are sold to sophisticated institutional investors and hence do not require a registration statement to be filed with the SEC. The securities involved in private placements can be either an initial issuance or a resale of previously issued securities and are generally restricted as to subsequent resale. For example, they may require registration under state and federal securities laws prior to resale or an opinion of counsel providing an exemption from registration requirements. The company's history, size, stability, and cash needs are factors in determining when the use of a private placement of debt or equity securities might be preferable to registering securities

for sale to the public. In many instances, the expertise of the broker-dealer may be essential in analyzing the company's activities and requirements in order to determine the kind of securities to be offered and to assist in structuring the placement to enhance marketability. Because private placements are usually conducted on a best-efforts, agency basis by a broker-dealer, maximum consideration is normally given to locating an investor or a relatively small group of investors whose investment objectives closely parallel the expectations of the issuer.

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

Financing

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

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

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

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

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

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

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

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

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

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

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

1.111 In a tri-party repo, an independent institution acting in a custodial capacity enters into a tripartite agreement with the two counterparties to

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

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

Other Activities

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

1.114 Growers, processors, warehouse operators, and other dealers often buy and sell commodity futures for hedging purposes; that is, they transfer the price risk to speculators. Speculators buy and sell commodity futures because of the potential for a large return that could result from the leverage inherent in commodity futures trading. This leverage exists because a commodity contract controls a substantial amount of the commodity and only a small money payment (margin deposit) is made.[4]

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

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

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[4] The practice aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools*, second edition, provides practitioners with nonauthoritative, practical guidance on financial statements of future commission merchants, introducing brokers, and commodity pools. The publication is available on www.cpa2biz.com.

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

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

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

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

Chapter 2

Broker-Dealer Functions, Books, and Records

Introduction

Overview

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

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

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

Original Entry Journals

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

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

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

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

2.06 A broker-dealer may keep separate blotters to record different types of transactions. For example, a broker-dealer may keep a clearinghouse blotter to record purchases and sales of cleared securities transacted on an exchange in

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

General Ledger

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

Stock Record

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

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

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

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

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

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

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

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

Regulatory Recordkeeping Requirements

2.13 The basic requirements for preparing and maintaining books and records are described in Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934. In Rule 17a-3, the Securities and Exchange Commission (SEC) specifies the minimum books and records a broker-dealer should maintain. They include a complete set of financial accounting books and records, including books of original entry, general and subsidiary ledgers, and the stock record. Rule 17a-3 also sets forth other recordkeeping requirements of broker-dealers. Among other things, Rule 17a-3 states that broker-dealers should maintain a memorandum of each brokerage order and a memorandum for each purchase and sale of securities for its own account, showing the price and, to the extent feasible, the time of execution. The rule also specifies that the broker-dealer should maintain certain records regarding transactions of employees and customers, as well as a periodic trial balance and net capital, reserve formula, and other regulatory computations. Such books and records should be maintained for prescribed periods as set forth in Rule 17a-4. In November 2001, the SEC adopted amendments to Rule 17a-3 and the record retention requirements in Rule 17a-4. Among other things, the amendments to Rule 17a-3 revised the information recorded on order tickets and added requirements to collect certain account record information, and periodically provide that information to customers for verification. The amendments to Rule 17a-3 also added requirements to create certain records related to associated persons, a record of customer complaints, a record indicating compliance with applicable advertising

rules, and records identifying persons responsible for establishing procedures and persons able to explain the broker-dealer's records to a regulator.

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

Trade Date and Settlement Date

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

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

Standardized Settlement Dates

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

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

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

account. Trade date information is also important to the operations departments to assist them in settlement and clearance.

Trade Execution

Customer Trades

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

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

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

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

2.21 Exchange trading is normally done in round lots (usually 100 shares), and a bid and offer on a security is usually made for the minimum unit of trading. A customer may accept a partial execution, in units of trading, unless the order is marked *all or none* or *fill or kill*. A customer's order to buy or sell is generally transacted as soon as possible after its receipt on the exchange floor or in the broker-dealer's trading area. An order is considered valid only for the day of the order; however, a customer can enter an order as good till canceled (GTC) or an open order, which is valid for longer than 1 day. The customer can cancel a GTC order if no action has been taken before the cancellation is

received. Customers may enter good-through-the-week and good-through-the-month orders for bonds.

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

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

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

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

2.25 *Order entry*. The completed order ticket is entered into the system, which accepts and reviews the ticket and relays the customer's instructions to the exchange floor or trading desk where it is to be executed. The exchanges have developed systems, whereby an order is routed to an automated order matching system depending on its size or price restriction. In addition, some firms have developed internal order matching systems. Once the order has been executed, the transaction is confirmed with the customer. Information concerning executed trades is sent to the purchase and sales (P&S) department,

which is responsible for ensuring that system-generated trade confirmations are correct and mailed to customers.

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

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

2.28 An executed trades report containing the terms of the executed orders is generated daily to facilitate further processing. Executed trades reflecting the purchase or sale of securities are recorded on a blotter, but they are generally not posted to the firm's general ledger and stock record until the settlement date. Instead, they are held in a pending file and posted on a memo basis to margin records and a bookkeeping journal.

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

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

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

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

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

which the security is held in the account or in reliance on an agreement that the customer owns the security and will make prompt delivery.

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

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

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

2.35 Regulation T establishes the maximum loan value of the securities in the account and requires the broker-dealer to obtain a deposit of cash or securities necessary to meet the initial margin requirement within two business days after the settlement date. That two-day period may be extended for one or more limited periods by applying to a national securities exchange or to FINRA. Maximum loan values for securities and a listing of marginable securities are prescribed periodically by a supplement to Regulation T. Certain securities exchanges have rules establishing minimum maintenance margin requirements, for example, New York Stock Exchange Rule 431.[1] A broker-dealer may establish initial or maintenance margin requirements that are greater than those required by the rules of the regulatory bodies.

2.36 A *short sale* is a sale of a security that the seller does not own.[2] Before a broker-dealer can execute a short sale for a customer, it must know

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[1] Following the consolidation of National Association of Securities Dealers (NASD) and New York Stock Exchange (NYSE) regulations into the Financial Industry Regulatory Authority (FINRA), NASD rules and certain NYSE rules were combined to form the FINRA Transitional Rulebook. The incorporated NYSE rules apply only to those members of FINRA that are also members of NYSE (dual members). FINRA has established a process to develop a new consolidated rule book that will apply to all FINRA members. Work is continuing on this consolidation of rules. The Securities and Exchange Commission (SEC) must approve the rules that will make up the new Consolidated FINRA Rulebook. See the FINRA website at www.finra.org/Industry/index.htm for more information.

[2] *Naked short selling*, or *naked shorting*, is the practice of short-selling a financial instrument without first borrowing the security or ensuring that the security can be borrowed, as is conventionally done in a short sale. When the seller does not obtain the shares within the required time frame, the

(continued)

that it can obtain the security. The broker-dealer is expected to borrow the security if necessary on behalf of the customer for the purpose of satisfying the delivery requirements. Short sales are governed by the margin requirements of Regulation T and the rules of self-regulatory organizations. A short sale account should be used to record transactions where securities are sold short.

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

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

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

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

- Determines initial margin
- Maintains customer accounts
- Controls the extension of credit
- Checks the credit status of customers
- Controls payments from accounts
- Initiates margin calls
- Processes and monitors applications for extensions of time for cash account customers to pay for securities purchased and for margin account customers to meet initial margin requirements

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(footnote continued)

result is known as a "fail to deliver." The transaction generally remains open until the shares are acquired by the seller, or the seller's broker, allowing the trade to be settled. Naked short selling is illegal in the United States, as well as other jurisdictions, as a method of driving down share prices. In the United States, naked short selling is covered by various SEC regulations that prohibit the practice. As part of its response to the crisis in the North American markets in 2008, the SEC issued a temporary order restricting short-selling in the shares of 19 financial firms deemed systemically important, by reinforcing the penalties for failing to deliver the shares in time. Effective September 18, 2008, the SEC extended and expanded the rules to remove exceptions and to cover all companies, including market makers.

- Issues instructions for moving securities to or from safekeeping or segregation
- Maintains copies of documents pertaining to transactions

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

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

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

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

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

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

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

Proprietary Trades

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

2.47 With a dealer strategy, the broker-dealer attempts to balance buy and sell transactions with different customers or other broker-dealers and earn the difference between the price paid on the purchase (bid) and the price received on the sale (ask). If a broker-dealer cannot simultaneously execute a buy and corresponding sell, the firm is at risk to market volatility during the time between execution of the purchase and execution of the sale. Hedging strategies[3] are often employed to minimize that risk.

2.48 Positioning strategies involve the broker-dealer's buying and selling securities in anticipation of certain market movements and holding such positions for longer periods than with dealer strategies. If a trader anticipates that a security's price will rise, the trader may take a long position in that security; if a security is expected to decline in value, the trader may take a short position. Positioning strategies are riskier than dealer strategies because the security is held for a longer time. If a trader incorrectly forecasts the market, losses can be incurred.

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

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

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

2.52 Participating underwriters maintain records of each underwriting participation only to the extent they are involved. To spread the risk of an underwriting and facilitate its distribution, the underwriters may sell all or part of the securities directly to the public or to a selling group that in turn sells the securities to the public. If an issue is not fully sold, the liability is shared among the participating underwriters through either an undivided or divided arrangement. An undivided liability is an arrangement whereby each member of an underwriting syndicate is liable for its proportionate share of unsold securities in the underwriting account regardless of the number of securities it has previously sold. Under divided liability, the member's liability for an underwriting is fixed or definite in amount. Selling groups are not underwriters

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[3] Hedge accounting is permitted only if the requirements of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 815, *Derivatives and Hedging*, are met.

and have no obligation to sell the securities allocated to them. Accordingly, they are entitled only to a selling concession.

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

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

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

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

Clearance and Settlement

Overview

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

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

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

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

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

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

Comparison

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

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

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

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

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

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

Settlement

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

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

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

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

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

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

2.72 Although most securities are held in book entry form, the procedures used in the handling of physical securities are described in the following paragraphs. Procedures performed relating to such settlement of transactions

usually begin on the day prior to the settlement date with the receipt of blotters of trades scheduled to be settled the next business day. Accompanying the blotters are receive and deliver tickets for transactions to be settled directly with other broker-dealers and transactions to be settled through the clearing organization. Physical securities are delivered to the clearing organization with the delivery tickets attached on the settlement date.

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

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

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

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

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

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

2.79 Fails are forwarded for entry to the stock record (securities) and general ledger (money). Normally, an updated file of open fails is produced daily. When a fail is cleared (securities having been either received or delivered versus payment), the date of the clearance is noted and the fail position is cleared

from the broker-dealer's records. A fail position may require the broker-dealer to *buy in* (see the glossary) the security if the fail is outstanding longer than the time period specified by SEC Rule 15c3-3.

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

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

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

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

Bookkeeping

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

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

2.86 Debit money balances and short security positions that cannot immediately be identified and cleared are recorded in suspense accounts. They reflect

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

Specialized Clearance Activities

Mortgage-Backed Securities

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

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

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

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

2.91 A significant amount of MBS trading occurs in TBAs. The broker-dealer maintains accounting subledgers that reflect outstanding TBA buy and sell transactions. TBA transactions can be settled by receiving or delivering pools pursuant to the terms of the trade (within 2 percent of the trade amount), or by offsetting the trade through an offsetting TBA purchase or sale. In both cases, accurate subledgers are important to calculate properly the pools received or delivered pursuant to the TBA transactions.

Government Securities

2.92 Treasury issues (with the exception of registered securities) and many U.S. government agency securities are available in book entry form through

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

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

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

Repos and Reverse Repos

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

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

Derivative Securities

2.97 FASB ASC 815, *Derivatives and Hedging*, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts.[4] See the "Derivatives" section in chapter 7 of this guide for discussion of FASB ASC 815. Derivative products (such as interest rate and currency swaps, swaptions, caps, and floors) involve certain unique settlement procedures. The settlement of these products does not involve the delivery of physical or book entry securities, but rather involves only cash exchanges between counterparties based on interest rates and notional or contract accounts. Settlement procedures for interest rate swaps require the monitoring and calculation of the required interest payment for the floating rate cash flow and the calculation of the fixed-rate interest payment for the fixed-rate cash flow. Once these amounts are determined on the interest payment date, the cash payments are then transmitted to the appropriate counterparty by the method specified in the master swap agreement, such as wire or check. Often, a broker-dealer will have more than one swap agreement with a counterparty. If a master netting agreement is in place, the counterparty may net the interest payments or receipts and one net cash payment will be made to or from the broker-dealer on the interest payment date. The floating rate cash flow of an interest rate swap is continually updated, as specified under the terms of the swap agreement, to enable the broker-dealer to calculate the interest payment or receipt from the contract and also to calculate unrealized gain or loss on a contract.

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

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

Commodity Futures and Options on Futures

2.100 The underlying commodities in the commodity futures contracts currently traded include grains, soybeans, rice, potatoes, sugar, coffee, and other foodstuffs; cotton; meat products such as live and feeder cattle, pork bellies and live hogs, and broilers (chickens); precious and other metals including gold, silver, copper, palladium, and platinum; foreign currencies; and energy products such as crude oil, heating oil, and leaded and unleaded gasoline. Contracts in

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[4] Broker-dealers value investments in trading securities and hedges at *fair value*. This practice is an important one to consider in a review of the provisions of FASB ASC 815.

financial instruments such as U.S. Treasury bills, bonds and notes, Government National Mortgage Association securities, bank certificates of deposits, and Eurodollars are traded by those who wish to speculate or hedge using various interest rate futures. Also, stock index futures contracts are used for hedging portfolios[5] or for speculating against changes in stock market prices. Most commodity futures contracts can be settled by taking or making delivery of the actual underlying commodity. Futures on stock market indexes and certain other futures are settled in cash. Exchange-traded options on futures contracts are settled through the delivery of the related futures contract by book entry. Although a futures contract may be settled by delivery, virtually all of the commodity futures and option contracts are not settled by delivery, but rather with an offsetting purchase or sale of the same futures or options contract.

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

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

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

[5] See footnote 3 in paragraph 2.47.

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

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

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

Forward Transactions

2.105 *Forward transactions* (*forwards*) are defined as existing trade commitments with settlement dates subsequent to regular-way trades (see paragraphs 7.50–.52). They may have a time differential of up to one year or more, and are thus traded on a delayed delivery or forward basis. These transactions are normally recorded on memo records (such as a pending or when-issued file), which are confirmed on a regular basis similar to other customer positions that have settled. The accounting for those forward transactions is to recognize the gain or loss on a current basis (that is, by valuing the individual transaction on a current basis). See the "Derivatives" section in chapter 7 of this guide for a discussion of FASB ASC 815, which establishes the accounting and reporting standards for derivative instruments and for hedging activities.

Municipal Securities

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

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

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

International Securities

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

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

sales are allowed in the trading environment, if a stock loan is a business in that market, and what the regulatory issues relating to contract closeouts are.

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

Options on Securities

2.109 The books and records required to be maintained by a general securities broker-dealer are also required of an options clearing firm under SEC Rules 17a-3 and 17a-4. An order ticket is required for each option transaction and should contain all relevant information, including the type of account (customer, firm, or market maker), whether the transaction is a put or a call, whether it is a purchase or sale, the underlying trading unit, the exercise price, the expiration date, the premium per unit, and the purchasing and writing clearing members. In addition, the clearing firm should maintain a separate P&S blotter and a separate position record for all option transactions for itself and its customers or market makers. See paragraphs 2.13, 2.24, and 2.29 for discussions of amendments to Rules 17a-3 and 17a-4.

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

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

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

2.112 The OCC issues a daily position report, which lists all option activity and ending positions for all accounts carried by the OCC member broker-dealer and the net daily pay or collect amount due to or from the OCC. The OCC also

issues a margin report, which shows the OCC margin requirement on the aggregate short option positions and exercised contracts for each account carried by the OCC member broker-dealer. Required margin may be paid by cash, check, government securities, common stocks with a market value as specified by the rules, or an irrevocable letter of credit issued by an OCC-approved bank or trust company.

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

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

Reconciliation and Balancing

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

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

2.117 Securities differences may be caused by inaccurate recordkeeping on the part of a broker-dealer, by an out-of-balance condition in the stock record (a stock record break), or by errors in the receipt and delivery of securities. Such differences are normally disclosed through the automated daily balancing of

the stock record, periodic counts of securities on hand, and examination or confirmation of items such as transfers and fails.

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

Custody*

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

Possession or Control

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

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

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

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* Registered investment advisers may be subject to significant requirements as a result of amendments to Rule 206(4)-2 (the rule) of the Investment Advisers Act of 1940. The rule includes a revision of an existing surprise examination requirement and introduces an internal control examination requirement. See chapter 3, "Regulatory Considerations," of this guide for more information on how this amendment impacts a broker-dealer that is also a registered investment adviser.

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

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

Securities Transfer

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

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

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

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

2.127 The transfer department sends registered securities to transfer agents to be reregistered in the new owners' names. Transfer agents (often banks) maintain the company's list of owners. The certificates should be

endorsed by the registered holder and authorized by a power of attorney. Reregistration may be made in the name of the beneficial owners or a nominee. Registration of certificates has been curtailed through the use of depositories.

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

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

Dividends, Interest, and Reorganization

Dividends and Interest

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

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

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

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

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

usually use information provided electronically by dividend-reporting services to identify information regarding dividend dates.

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

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

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

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

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

Reorganization

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

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

2.141 Mandatory exchanges are generally processed for customers on the effective date. They include mergers, splits and reverse splits, subscriptions,

consolidations, acquisitions, exchanges of convertible securities into common stocks, and certain called securities.

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

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

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

Collateralized Financing

Stock Loan and Stock Borrow[6]

2.144 Securities not available to be delivered on the settlement date may be borrowed. A stock borrow occurs when a broker-dealer needs a security to deliver against a settling transaction, such as a short sale. A short sale is the sale of a security not owned by the firm or a customer. Short sales are often made in anticipation of a market decline or as part of a trading or hedging strategy.[7] In addition, a broker-dealer may be involved in a finder's business, whereby securities are borrowed to relend to another broker-dealer, thus allowing the broker-dealer to earn a spread on the transaction. Broker-dealers may also engage in equity securities borrowed transactions solely for financing the positions of another broker-dealer where the equity securities are initially borrowed without a "permitted purpose" pursuant to Regulation T Section 220.10(a) and placed in a box location. These transactions, which are referred to as *nonpurpose borrows*, have regulatory implications that need to be considered in the computation of net capital.

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[6] Rule 203, *Borrowing and Delivery Requirements*, of SEC Regulation SHO contains requirements and guidance for brokers and dealers related to the long and short sales of equity securities.

[7] See footnote 3 in paragraph 2.47.

2.145 In general, broker-dealers borrow securities to deliver them to another broker-dealer or to a customer, often leveraging utilities like LOANET (see the glossary) to do so. If the cashiering department needs to borrow securities, it instructs the stock loan department to borrow them. The borrowing broker-dealer is required to deposit cash or other collateral, which may be in the form of securities issued or guaranteed by the United States or its agencies, certain certificates of deposit or bankers' acceptances, or irrevocable letters of credit. When the borrowing broker-dealer deposits cash, it receives an interest-like rebate on the amount that was exchanged for the securities. This rebate is negotiated, with the rate usually established by the lender and agreed to by the borrower. If a security is difficult to obtain, a lower rebate would be acceptable. The borrowing broker-dealer records the transaction as a long on the stock record and as an asset in the general ledger (receivable from the lending broker). The lending broker records a short position on the stock record and a liability in the general ledger. FASB ASC 860, *Transfers and Servicing*, provides specific criteria for determining whether a securities lending transaction is to be accounted for as a sale or as a secured borrowing and provides an illustration of the latter.[8] (See chapter 7 of this guide for a discussion of secured borrowing.)

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

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

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

Bank Loan Financing

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

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

- The bank's name
- The type of loan (that is, firm, customer, or noncustomer, depending on the collateral pledged)

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[8] FASB ASC 860, *Transfers and Servicing*, among other matters, provides guidance for recognition and reclassification of collateral and for disclosures relating to securitization transactions and collateral.

- The loan amount
- The interest rate
- The quantity, description, and market value of securities used as collateral for the loan

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

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

Reverse Repos and Repos

2.152 Reverse repos are similar to securities-borrowed transactions except that reverse repos are generally executed with government and government-agency securities. Securities are usually borrowed to make deliveries on short sales, whereas reverse repos are frequently related to investment activities as well as meeting delivery requirements.[9]

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

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

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

2.156 The rights of parties involved in a repo or reverse repo transaction depend on the particular terms and conditions of the transactions that are documented in a written agreement or transaction confirmation. Most firms

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[9] Reverse repurchase agreements discussed in this guide are usually referred to as *repurchase agreements* by the investment company and banking industries.

use a standard agreement developed by the Bond Market Association (now SIFMA). The documentation diminishes uncertainties for such transactions. Written agreements should describe the transaction, the terms and conditions of the contract, and the rights of the parties, including the following:

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

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

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

Regulatory

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

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

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

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

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

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

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

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

Tax Information Reporting

2.166 A broker-dealer is required to file information returns with the IRS for certain customer transactions and to also send the related form(s) to the customer. Examples of the more common returns and of the information they provide include the following:

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

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

2.168 The IRS has rules regarding what action to take when a payee has provided an incorrect TIN. Certain notices should be sent to the payee.

[†] The Emergency Economic Stabilization Act of 2008 adds additional requirements. As a result of the new rules, financial institutions will be required to track investors' cost basis for stocks acquired on or after January 1, 2011; mutual fund shares and dividend reinvestment plans acquired in 2012; and debt instruments, options, and other securities acquired in 2013. If a client switches accounts to a new institution, the information will need to be transferred.

Under the new rules, every broker required to file a return under Section 6045(a) from the sale of a covered security will be required to include in the return the customer's adjusted basis in the security and whether any gain or loss with respect to that security is long-term or short-term.

This requirement to have systems to track and report cost basis information will likely require substantial changes to a broker-dealer's internal operations. In addition, both taxpayers and broker-dealers will likely encounter difficulties in determining the cost basis of certain securities. Although the regulations related to the new requirements are not final as of the date of this guide, the IRS has placed information on the proposed regulations, including a draft Form 1099-B, on the "Third Party Reporting Information Center" section of its website at www.irs.gov/taxpros/article/0,,id=225080,00.html. Readers are encouraged to visit this site for additional information on the new requirements and for information on recent developments.

Depending on the situation, the broker-dealer may be required to begin backup withholding and to continue backup withholding until notified by either the IRS or the Social Security Administration to stop. Once again, failure to withhold when required to do so will result in the payor being held responsible for the tax. Publication 1281, *Backup Withholding for Missing and Incorrect Name/TIN(s)*, is available on the IRS website and contains information and forms related to backup withholding.

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

Illustrative Stock Record Entries

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

1. Customer A buys 100 shares of ABC at $20.00 per share. Note that the entry assumes the securities are not received on the settlement date.

Stock Record	*(Quantity)*	*General Ledger*	*($)*
Long—Customer A	100	Dr. Customer A	2,000
Short—Fail to Receive	100	Cr. Fail to Receive	2,000

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

Stock Record	*(Quantity)*	*General Ledger*	*($)*
No entry needed		Dr. Cash	2,000
		Cr. Customer A	2,000

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

Stock Record	*(Quantity)*	*General Ledger*	*($)*
Long—Stock Borrow	100	Dr. Stock Borrow	2,000
Short—DTC	100	Cr. Cash	2,000

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

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

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

Stock Record	*(Quantity)*	*General Ledger*	*($)*
Long—DTC	100	Dr. Cash	2,000
Short—Stock Loan	100	Cr. Stock Loan	2,000

6. Customer B sold 200 shares of DEF at $30.00 per share. Note that the entry assumes the securities were in transfer and therefore not delivered on the settlement date.

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

7. DEF was delivered through DTC.

Stock Record	*(Quantity)*	*General Ledger*	*($)*
Long—DTC	200	Dr. Cash	6,000
Short—Fail to Deliver	200	Cr. Fail to Deliver	6,000

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

Stock Record	*(Quantity)*	*General Ledger*	*($)*
Long—DTC	200	No entry needed	
Short—Suspense	200		

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

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

10. The firm decides to buy 5000 shares of GHI at $2.00 a share for its inventory.

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

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

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

Chapter 3

Regulatory Considerations[*]

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

Applicable Rules

3.02 The Securities and Exchange Commission's (SEC's) rules require the auditor to be designated by the broker-dealer, in writing, to the SEC and to the examining authority, such as the Financial Industry Regulatory Authority (FINRA) or a securities exchange, of which the broker-dealer is a member. The primary rules[†] under the Securities Exchange Act of 1934 and other regulations that are applicable to the audits of broker-dealers in securities are as follows:[2,3]

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

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[*] The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) was signed into law by the president on July 21, 2010. One of the provisions of this act amends the Sarbanes-Oxley Act of 2002 to give the Public Company Accounting Oversight Board (PCAOB) full oversight authority over all broker-dealers, including standard setting, inspection, and enforcement. See the preface for more information on the Dodd-Frank Act.

[1] The Commodity Practice Aid Task Force of the AICPA has updated 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 provides practitioners with nonauthoritative, practical guidance on the financial statements of futures commission merchants (FCMs), introducing brokers (IBs), and commodity pools. The practice aid was released in June 2009 and is available at www.cpa2biz.com.

[†] The Securities and Exchange Commission (SEC) is considering amendments to the financial responsibility rules for broker-dealers. Originally proposed in SEC Release No. 34-55431, the amendments are expected to codify certain current interpretive guidance and are also expected to impose additional requirements related to broker-dealer custody of client funds and securities. It is important that readers be alert for further developments.

[2] Paragraphs 3.147–.148 of this guide provide additional discussion of rules adopted under the Securities Exchange Act of 1934 for over-the-counter (OTC) derivatives dealers who register with the SEC under a limited regulatory structure rather than under the usual broker-dealer regulatory regime of Securities Exchange Act of 1934 Section 15(b). Also, see paragraph 3.146 for a listing of rules under Title 17 U.S. *Code of Federal Regulations* (CFR) Chapter IV that are applicable specifically to government securities broker-dealers.

[3] See www.finra.org/Industry/Regulation/Guidance/FOR/index.htm to access many of these rules and related interpretations.

- Rule 17a-3, "Records to Be Made by Certain Exchange Members, Brokers, and Dealers"
- Rule 17a-4, "Records to Be Preserved by Certain Exchange Members, Brokers, and Dealers"
- Rule 17a-5, "Reports to Be Made by Certain Brokers and Dealers"
- Rule 17a-11, "Notification Provisions for Brokers and Dealers"
- Rule 17a-13, "Quarterly Security Counts to Be Made by Certain Exchange Members, Brokers, and Dealers"
- Rules 17h-1T and 17h-2T, "Final Temporary Risk Assessment Rules"
- Federal Reserve Regulation T (Regulation T) of the Board of Governors of the Federal Reserve System
- For broker-dealers that are also FCMs, Commodity Futures Trading Commission (CFTC) Regulations 1.10–1.32 and 30.7 (see also the CFTC website at www.cftc.gov for more information)[4]
- The Investment Advisers Act of 1940, for broker-dealers that are also registered as investment advisers under said act[5]

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

Interpretations of Rules

3.04 Interpretive guidance regarding the more pertinent financial responsibility rules can be accessed at www.finra.org/Industry/Regulation/Guidance/FOR/index.htm. Published interpretations of certain rules of the regulatory bodies[6] may be found in the following reference materials:

- Financial and Operational Combined Uniform Single (FOCUS) report forms and their general instructions (line item references to specific rules)[7]
- SEC interpretative releases (Securities Exchange Act of 1934 series) and published interpretative and no action letters[8]
- Treasury Department interpretations[9]
- FINRA manual[10] and regulatory notices

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[4] See paragraph 3.145 for more information on the regulations applicable to FCMs.

[5] See the discussion beginning at paragraph 3.135 for information on recent developments and new requirements for broker-dealers who are also registered investment advisers.

[6] Appendix M, "Information Sources," contains contact information for many of the organizations listed here.

[7] This form can be accessed at http://sec.gov/about/forms/secforms.htm.

[8] This form can be accessed at http://sec.gov/divisions/marketreg/mr-noaction.shtml.

[9] This information can be accessed at http://federalreserve.gov/boarddocs/legalint/.

[10] Following the consolidation of National Association Of Securities Dealers (NASD) and New York Stock Exchange (NYSE) Member Regulation into the Financial Industry Regulatory Authority (FINRA), the organization is establishing a consolidated rulebook and a single set of FINRA rules. This consolidation of rules, the FINRA manual, consists of three sets of rules—FINRA rules, NASD rules, and incorporated NYSE rules, with the latter only applicable to members of FINRA

(continued)

- CFTC Interpretations and Advisories
- Interpretative instructions distributed to their respective memberships by other self-regulatory organizations
- Published securities services (Commerce Clearing House, Prentice-Hall, and *Securities Regulation and Law Report*)

3.05 Inquiry concerning whether the broker-dealer has requested and received specific interpretations from any regulatory agency since the prior audit will assist the auditor in giving the issue appropriate consideration to their effect, if any, on the financial statements of the broker-dealer being audited.

Explanation of Significant SEC Financial Responsibility Rules

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

3.06 In Securities and Exchange Release 34-9856, the SEC announced that the Customer Protection Rule was designed to accomplish the following purposes:

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

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(footnote continued)

that are also members of the NYSE (dual members). FINRA rules apply to all FINRA members, unless such rules have a more limited application by their terms, and are being proposed in phases to the SEC. As rules approved by the SEC become effective, they will replace the existing NASD rules and certain incorporated NYSE rules. To assist members during the consolidation process, FINRA has created rule conversion charts to show how the new FINRA rules relate to the NASD and incorporated NYSE rules that they replace. This information is available on the FINRA website at www.finra.org/Industry/Regulation/FINRARules/P038095.

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

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

3.08 National Association Of Securities Dealers (NASD) Notice to Members 98-99 extends the requirement to perform a Customer Reserve Computation with respect to proprietary accounts of introducing brokers (PAIB) carried by their clearing brokers in order for an introducing broker to receive allowable asset treatment under Rule 15c3-1 for proprietary assets held at a carrying and clearing broker. The introducing broker and its carrying and clearing broker must agree in writing to perform the PAIB reserve calculation under the methodology outlined in the no action letter attached to the interpretation memo. Additional guidance on PAIB is found in NASD Notice to Members 99-44.

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

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

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

- Brokers or dealers
- Municipal securities dealer, or a government securities broker or government securities dealer
- General partner, managing member of a limited liability company or director or principal officer of the broker or dealer
- A counterparty who has delivered collateral to an over-the-counter (OTC) derivatives dealer who registers with the SEC under a limited regulatory structure, as discussed in paragraph 3.147 of this guide, pursuant to a transaction in an eligible OTC derivative instrument or pursuant to the OTC derivatives dealer's cash

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

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

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

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

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

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

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

a. A temporary business lag between the time when a security is required to be in the possession or control of the broker-dealer and the time it is taken into physical possession or control is one exception. The broker-dealer must show that it is making a timely and good faith effort to establish prompt physical possession or control.

b. The broker-dealer borrows from its customer fully paid-for or excess-margin securities that it is required to have in possession or control and enters into a written securities-borrowing agreement with the customer setting forth the compensation for the securities borrowing, the rights or liabilities of the parties, and the identity of the securities borrowed at the time of the borrowing. The agreement should also specify that upon the execution or at least by the close of the business day of the securities borrowing, the broker-dealer is to provide the customer with certain qualified collateral at least equal to the market value of the securities borrowed and must mark the securities borrowed to the market not less than daily. The agreement should also contain a prominent notice that the provisions of the Securities Investor Protection Act of 1970 may not protect the customer with respect to the securities loaned.

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

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

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

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

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

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

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

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

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

acknowledges that it, or another party through it, cannot impose a lien or claim on such securities.[11]

- in transfer for less than 40 calendar days or, if beyond 40 days, confirmed as being in transfer (the securities are the subject of bona fide items of transfer).
- in the custody of a foreign depository, foreign clearing agency, or foreign custodian bank as designated by the SEC.[12]
- in transit for five business days or less between the offices of a broker-dealer (for example, between the main and branch offices).
- in a special omnibus account carried for the account of any customer by another broker-dealer and carried in the name of the broker-dealer in compliance with Regulation T (such securities are considered in control to the extent that the broker-dealer has instructed the carrying broker-dealer to maintain physical possession or control of them free of any charge, any lien, or any other claim in favor of the carrying firm).

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

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

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

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

3.26 In addition, SEC Rule 15c3-3 stipulates the designated times for performing the computations as follows:

- For broker-dealers required to make weekly computations, the computations should be made as of each week's end and at month's

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[11] See the bullet regarding foreign depositories because it may apply to United States-based banks holding customer foreign securities.

[12] Note that this may be problematic due to the use by the designated domestic or foreign custodian of subcustodians, over which the former has no control.

end (that is, the last business day of the week or month), with necessary deposits made no later than one hour after the opening of banks on the second business day after the computation date. The computation is not required for the week's end following a computation at month's end.

- Monthly computations should be made only if the broker-dealer does not have aggregate indebtedness in excess of 800 percent of net capital and has less than $1 million in customer credits. Deposits are also due no later than 1 hour after the opening of banks on the second business day after the computation date.

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

3.28 *Bank sweep products.* For several years, certain broker-dealers that carry customer accounts have utilized "bank sweep products" as a means to place customer funds in a bank account subject to Federal Deposit Insurance Corporation (FDIC) coverage. Although such broker-dealers assert that customer funds are better protected, regulators have questioned the large interest rate spreads earned by the broker-dealers in such arrangements, the nature and extent of disclosure that the broker-dealers provide their customers regarding the interest rate differential, and whether the arrangements are structured such that the broker-dealers have satisfactorily given up possession of the customer funds.

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

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

3.31 In the interim, auditors should obtain from management sufficient and competent evidential matter that, in all material respects, any such arrangement abides by the guidance and certain requirements set forth in Information Memo 05-11. If asserted by management, auditors should verify whether the customer funds under a bank sweep arrangement are covered, in full, by the FDIC, or otherwise recognized by the broker-dealer as customer

payables and that such payables and any related receivables are reflected appropriately in the broker-dealer's net capital and customer reserve computations.

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

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

3.34 In auditing the financial statements of a broker-dealer claiming exemption from SEC Rule 15c3-3, the auditor should determine whether and to what extent the broker-dealer complied with the specific exemption during the audit period as well as the quality of the broker-dealer's controls and procedures to ensure ongoing compliance. For example, a broker-dealer whose customers' accounts are carried on a fully disclosed basis at another broker-dealer would not have to comply with the reserve requirements as stated in SEC Rule 15c3-3. However, the independent auditor[13] should ascertain that the broker-dealer did not have possession or control of customer funds or securities such that it would be considered as carrying customer accounts.

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

3.36 In reporting on a broker-dealer exempt from SEC Rule 15c3-3, the schedules titled "Computation for Determination of Reserve Requirements Under Rule 15c3-3" and "Information for Possession or Control Requirements Under Rule 15c3-3" are still required, but such computations and information are not applicable. In lieu of the computations and information, a statement should be included indicating the section under which exemption is claimed. With respect to the effect of the exemption on the "Independent Auditor's Supplementary Report on Internal Control," see appendix D, "Report on Internal Control Required by SEC Rule 17a-5 for a Broker-Dealer Claiming an Exemption From SEC Rule 15c3-3," of this guide.

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[13] As discussed in footnote ‡‡ at paragraph 3.84, financial statements of nonpublic broker dealers filed with the SEC must be certified by a PCAOB registered public accounting firm. The term "independent auditor," as used in this guide, assumes the firm is registered with PCAOB, as required.

SEC Rule 15c3-1, "The Uniform Net Capital Rule"[‡]

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

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

- The broker-dealer's capital (equity plus qualified subordinated indebtedness) is reduced to give effect to the elements of market, credit, or operational risk inherent in the business in which the broker-dealer currently is engaged.
- The minimum capital that the broker-dealer is required to maintain pursuant to SEC Rule 15c3-1(a) is established on the basis of the greater of either (*a*) the amount of the broker-dealer's aggregate indebtedness (that is, the broker-dealer's obligations payable in cash, with limited exceptions) or (*b*) the level of customer-related receivables (aggregate debit items) computed pursuant to SEC Rule 15c3-3 (the alternative method), and a minimum amount based on the broker-dealer's business activities.[14]
- If the broker-dealer is also registered as an FCM, it should maintain net capital equal to the greater of
  - — the selected SEC Rule 15c3-1 method previously described or 4 percent of the amount required to be segregated pursuant to the Commodity Exchange Act and related regulations (less the market value of commodity options purchased by option customers on or subject to the rules of a contract market, each such deduction not to exceed the amount of funds in the customer's account), or
  - — the minimum financial requirements for an FCM, including the risk-based requirement, and introducing brokers (IBs) pursuant to CFTC Regulation 1.17a-1-i, including under (c) the amount of adjusted net capital required by the National Futures Association.[||]

3.39 In each case, the level of capital is established to ensure that, in the event of a liquidation, the broker-dealer is maintaining sufficient capital to ensure (1) the payment of its obligations to customers and other broker-dealers and (2) compensation to employees retained to wind up the firm's affairs.

3.40 By monitoring the maintenance of liquid assets in excess of the minimum requirements, the SEC and the examining authority are in a position

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[‡] Please refer to paragraphs 3.28 for a discussion of the potential impact of cash sweep account programs on broker-dealer's compliance with net capital requirements.

[14] Pursuant to Rule 15c3-1(a)(ii) a broker-dealer may elect to be subject to the alternative method rather than the basic method by notifying its examining authority in writing.

[||] On March 31, 2010, the revised adjusted net capital requirements found in 17 CFR Part 1.17 became effective for FCMs and IBs, as published in Federal Register Notice 74 FR 69279.

to take action to protect customers prior to the time when the broker-dealer's assets would be insufficient to satisfy customers' claims in the event of liquidation.

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

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

3.43 There are basically two parts to the net capital computation: (*a*) determination of net capital (as described in paragraphs 3.48–.49) and (*b*) comparison with aggregate indebtedness or alternative percentage requirements.

3.44 Under the aggregate indebtedness method, the broker-dealer's net capital requirement is equal to $6\frac{2}{3}$ percent of its aggregate indebtedness. A broker-dealer is not permitted to allow its aggregate indebtedness to exceed 15 times its adjusted net capital. If the ratio of aggregate indebtedness to adjusted net capital exceeds 15 to 1, the broker-dealer is prohibited from engaging in any securities transactions. If the ratio exceeds 12 to 1, the broker-dealer may be required to reduce its business. If it exceeds 10 to 1, the broker-dealer may be prohibited from expanding its business.

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

3.46 The aggregate indebtedness and alternative standards are 1 measure of a broker-dealer's net capital requirement, the other measure is the minimum net capital amount required as a result of the broker-dealers securities activity. A broker-dealer's net capital requirement is higher of the selected standard or the minimum level. For example, if a broker-dealer engages in proprietary trading and selects the aggregate indebtedness standard, its net capital requirement is the greater $6\frac{2}{3}$ percent of its aggregate indebtedness or $100,000.

3.47 Percentage requirements also restrict the withdrawal of equity capital and the repayment of subordinated obligations and the making of any

unsecured advance or loan to a stockholder, partner, sole proprietor, employee, or affiliate.

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

- Certain liabilities, approved by the examining authorities, that have been subordinated to the claims of general creditors. The extent to which these liabilities may be included in capital is subject to limitations. Standardized subordination, secured demand note, and secured demand note collateral agreements are available from FINRA, and all executed agreements should be approved by the broker-dealer's designated self-regulatory organization before they qualify for capital purposes. A subordination agreement[15] should meet the following requirements:
  - Be written
  - Have a minimum term of one year
  - Be for a specific dollar amount
  - Effectively subordinate the lender's right to prior payment of all claims of present and future creditors
  - Give the broker-dealer the right to deposit any cash proceeds in its own name in any bank, as well as the right to pledge or hypothecate securities without notice
  - Include certain prepayment restrictions
  - Suspend the repayment or maturity obligation if, after giving effect to the obligation, the aggregate indebtedness of the broker-dealer would exceed 1,200 percent of its net capital or its net capital would be less than 6 percent of aggregate debits if the alternative capital method were used
- Certain discretionary liabilities. A noncontractual bonus accrual that is not a fixed payable as of the computation date is the most common type of discretionary liability that may, upon certain criteria, be added back to total equity.
- Deferred income tax liabilities resulting from the recognition for tax purposes of unrealized income or appreciation related to long inventory or investment positions or to assets that are nonallowable for net capital; and deferred income tax benefits resulting from the recognition for tax purposes of unrealized losses or depreciation related to long inventory or investment positions, but only up to the extent of recognized income tax liabilities. Please see the specific requirements contained in Rule 15c3-1 and related interpretations.

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

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[15] For more information, see the specific requirements contained in the debt-equity requirements of Rule 15c3-1 and appendix D to SEC Rule 15c3-1.

a. Nonallowable assets. These are recognized assets that do not meet liquidity tests or have been defined as nonallowable by Rule 15c3-1. In general, nonallowable assets are assets not readily convertible into cash. Examples of the most frequently encountered nonallowable assets are fixed assets, securities not readily marketable, unsecured receivables (certain receivables are allowable for the first 30 days), deficits in customer accounts, good-faith deposits, prepaid expenses, exchange memberships, and intangibles. Broker-dealers that retain cash or securities at their carrying and clearing broker-dealer should treat such assets as nonallowable unless the clearing broker agrees in writing to include the introducing broker's assets in its PAIB computation in accordance with the customer reserve computation.

b. Other deductions and charges. In general, these items are operational in nature and may involve off-balance sheet risk. These items include, for example, aged fails-to-deliver, over or under collateralized secured lending positions, and securities count differences.

c. Haircuts on proprietary positions and commitments. Haircuts are percentage deductions that are designed to take into account market and portfolio risk exposures on proprietary positions and commitments. They apply to marketable securities only.[16]

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

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

3.52 *Expense-sharing agreements*. Many broker-dealers enter into what is generally referred to as an expense sharing agreement with their parent or an affiliated company. The parent or affiliate is usually not registered as a broker-dealer, and accordingly, is unregulated. In certain instances, a parent or an affiliate has established a broker-dealer to conduct limited or specialized securities activities that are coincidental or tangential to the operations of the parent or affiliate. In other instances, the parent or affiliate will have limited operations and will conduct separate financial activities using funds obtained from the broker-dealer's operations. In either case, the broker-dealer and the

[16] An OTC derivatives dealer who registers with the SEC under a limited regulatory structure, as discussed in paragraph 3.147 of this guide, may apply to the SEC for authorization to compute capital charges for market and credit risk pursuant to appendix F to Rule 15c3-1 in lieu of computing securities haircuts pursuant to Rule 15c3-1(c)(2)(vi).

parent or affiliate are likely to incur common costs, such as rent, and, as a result, devise an arrangement to allocate or assign direct or general (or both) overhead costs between them and specify which party will settle the related obligations. Thus such an arrangement will deal with both cost recognition and payment responsibility.

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

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

SEC Rule 17a-13, "Quarterly Security Counts"[#]

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

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

[#] See the discussion beginning at paragraph 3.135 for additional requirements for broker-dealers that are also registered investment advisers.

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

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

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

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

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

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

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

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

Regulation T and Maintenance Margin

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

3.61 Section 8 of Regulation T governs cash accounts. This type of account was created by Regulation T for those transactions in which the broker-dealer is not extending credit to the customer. The broker-dealer may purchase for

(as agent) or sell to (as principal) a customer any security, provided that either (*a*) funds sufficient for the purpose are already in the cash account or (*b*) the purchase or sale is in reliance on an agreement accepted by the creditor in good faith that the customer will promptly make full cash payment before selling and does not contemplate selling the security prior to such payment.

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

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

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

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

3.66 FINRA,[**] applicable exchanges, and broker-dealers themselves may set margin requirements that are higher than those specified in Regulation T. There is one major difference between these requirements and the requirements of Regulation T. Regulation T is an initial requirement. The FINRA requirements are initial and maintenance requirements. This simply means that, unlike Regulation T, these requirements apply to the initial trades and to the position that is retained in the account. In addition, many broker-dealers maintain "house" margin requirements (both initial and maintenance) that are higher than those established by FINRA.

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

3.67 The CFMA (see paragraph 1.44 of this guide) provided for the issuance of rules governing customer margin for transactions in security futures.

[**] In the July 16, 2010, Federal Register, notice of SEC approval of FINRA's proposed rule change related to margin requirements was published. See Federal Register notice 75 FR 41562 for more information.

Specifically, the CFMA directed the Federal Reserve Board to prescribe rules establishing initial and maintenance customer margin requirements. SEC Rules 400–406 and CFTC Rules 41.42–.49 were issued in August 2002 establishing margin requirements for security futures pursuant to joint authority delegated by the Federal Reserve Board.

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

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

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

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

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

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

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

is allowed to satisfy the filing requirements by submitting certain reports filed for the MAP with its primary regulator.

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

3.72 SEC Rule 17a-5 describes the objectives of an audit of a broker-dealer's financial statements. Specifically, the audit should be made in accordance with generally accepted auditing standards and should include a review of the accounting system, internal control, and procedures for safeguarding securities including appropriate tests for the period since the prior examination date. The audit should include all procedures necessary under the circumstances to enable the independent public accountant to express an opinion on the statement of financial condition, results of operations, cash flows, and the "Computation of Net Capital under Rule 15c3-1, the Computation for Determination of Reserve Requirements for Brokers or Dealers under Exhibit A of Rule 15c3-3, and Information Relating to the Possession or Control Requirements Under Rule 15c3-3."[17]

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

- making the periodic computations of aggregate indebtedness and net capital under SEC Rule 15c3-1 and the reserve required by SEC Rule 15c3-3.
- making the quarterly securities examinations, counts, verifications, and comparisons and the recordation of differences required by SEC Rule 17a-13.
- complying with the requirement for prompt payment for securities under Section 8 of Regulation T.
- obtaining and maintaining physical possession or control of all fully paid and excess-margin securities of customers as required by SEC Rule 15c3-3.
- if the broker-dealer is also registered as an FCM, making the periodic computations of the minimum financial requirements pursuant to Regulation 1.17 under the Commodity Exchange Act, daily computations of the segregation requirements of Section 4d(a)(2) of the act and the act's regulations, and the secured amount requirements of the act and the act's regulations.

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[17] These requirements are located in SEC Rule 17a-5(g), *Audit Objectives*.

[††] Note that some of the internal control terminology used in SEC Rule 17a-5 has not been updated to reflect the terminology used in AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1). When making reference to Rule 17a-5, this guide uses the internal control terminology contained in Rule 17a-5 in order to remain consistent with SEC regulations.

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

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

3.76 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-dealer's financial statements

d. Result in violations of the SEC's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in the preceding three items.

3.77 AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), provides guidance on reports on internal control over financial reporting based solely on an audit of financial statements that are intended for the use of management and specific regulatory agencies. AU section 325 has been updated for the issuance of Statement on Auditing Standards (SAS) No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). Paragraph .06 of AU section 325 defines *a material weakness* as a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. (See paragraphs 5.122–.124 for a detailed discussion of the communication of matters related to internal control.)

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

3.79 The auditor's responsibility with respect to material inadequacies as described in SEC Rule 17a-5(h)(2) and CFTC Rule 1.16e-2 is as follows (see also chapter 6). The following is paraphrased from the SEC Rule 17a-5(h)(2):

> If, during the course of the audit or interim work, the independent public accountant determines that any material inadequacies exist in

the accounting system, internal control, and its operation including procedures for safeguarding securities, or as otherwise defined in subparagraph (g)(3), then he or she shall call it to the attention of the CFO of the broker-dealer, who shall have a responsibility to inform the SEC and the designated examining authority by telegraphic notice within 24 hours thereafter as set forth in paragraphs (d)–(f) of SEC Rule 17a-11.

The broker-dealer shall also furnish the accountant with a copy of said notice to the regulators within the 24-hour period. If the accountant fails to receive such notice from the broker-dealer within said 24-hour period, or if the accountant disagrees with the statements contained in the notice of the broker-dealer, the accountant shall have a responsibility to inform the SEC and the designated examining authority by report of material inadequacy within 24 hours thereafter as set forth in SEC Rule 17a-11. Such report from the accountant shall, if the broker-dealer failed to file a notice, describe any material inadequacies found to exist. If the broker-dealer filed a notice, the accountant shall file a report detailing the aspects, if any, of the broker's or dealer's notice with which the accountant does not agree.

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

3.81 The reports shown in appendix C, appendix D, and appendix F, "Report on Internal Control Required by CFTC Regulation 1.16 and SEC Rule 17a-5(g)(1)," of this guide[18] are appropriate if the auditor has completed the audit of the financial statements. If the auditor becomes aware of a material inadequacy that was corrected during the period but not reported by management to the SEC and the broker-dealer's designated examining authority, management's failure to report the condition would constitute a material inadequacy that should be included in the auditor's report on internal control. Pursuant to SEC Rule 17a-5(j), the report on internal control should be filed along with the annual audit report. Rule 17a-5(c)(2)(iii) provides that when the independent auditor has commented on a material inadequacy, the broker-dealer should include, in the statement of financial condition furnished to customers, a statement that a copy of such report is currently available at the principal office of the SEC and the SEC regional office for the region in which the broker-dealer has its principal place of business.[19]

3.82 The report shown in appendix E, "Letter to SEC When the Broker-Dealer Has Not Made the Required Notification," should be used if an audit has not been completed and if the independent auditor disagrees with the notification made by the broker-dealer, or if the broker-dealer has failed to make the notification deemed appropriate by the auditor. Consideration should be given

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[18] See also "SEC Requirements for Management's Report on Internal Control over Financial Reporting" beginning at paragraph 6.69 of this guide.

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

to the possible need to consult with legal counsel and to modify the report based on the particular circumstances.[20]

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

3.84 *Qualification of accountant*.[‡‡] The SEC does not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of his or her place of residence or principal office. The SEC also does not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of his or her place of residence or principal office.

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

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

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

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

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[20] See footnote 19 in paragraph 3.81.

[‡‡] Although the Sarbanes-Oxley Act of 2002 is directed at *issuers* (as defined by the act) and their auditors, privately held 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 (*Commerce and Trade*, *U.S. Code* [USC] Title 15, Section 78q) of the Securities Exchange Act of 1934 to require all broker-dealers (both public and private) to be audited by a public accounting firm registered with the PCAOB. The SEC deferral of this requirement expired on December 31, 2008. Therefore, for fiscal years ending after December 31, 2008, financial statements of nonissuer broker-dealers must be certified by a PCAOB registered public accounting firm. This registration requirement does not change the auditor requirements outlined in Rule 17a-5(g), which requires that audits of nonissuer broker-dealers be performed in accordance with generally accepted auditing standards. See chapter 5, "Auditing Considerations," for more information. See also footnote * at the chapter title for recent developments.

3.88 *Independence of accountant.*[21] SEC Rule 17a-5 requires that the provisions set forth in SEC Rules 2-01(b) and (c) of Regulation S-X be adhered to when determining whether the accountant is deemed to be independent.

3.89 *Replacement of accountant.* A broker-dealer is also required to file a notice with the SEC's principal office in Washington, DC, the SEC regional office for the region in which the broker-dealer's principal place of business is located, and the principal office of the designated examining authority for such broker-dealer, no more than 15 business days after any of the following:

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

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

3.91 The notice should state whether the accountant's report on the financial statements for any of the past two years contained an adverse opinion or a disclaimer of opinion or was qualified concerning uncertainties, audit scope, or accounting principles. The notice should also describe the nature of each such adverse opinion, disclaimer of opinion, or qualification. The broker-dealer should also request the former accountant to furnish the broker-dealer with a

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[21] In January 2003, the SEC adopted amendments to its requirements regarding auditor independence to enhance the independence of accountants who audit and review financial statements and prepare attestation reports filed with the SEC. Auditors of privately held broker-dealers are restricted from performing those services specifically excluded by the Sarbanes-Oxley Act of 2002 and are expected to comply with all other SEC independence rules, including those that prohibit bookkeeping and the preparation of financial statements for privately held broker-dealers. SEC answers to frequently asked questions regarding the independence rules can be found at www.sec.gov/info/accountants/ocafaqaudind121304.htm.

letter that is addressed to the SEC that states whether he or she agrees with the statements contained in the notice of the broker-dealer and, if not, states the respects in which he or she does not agree. The broker-dealer should file three copies of the notice and the accountant's letter, one copy of which should be manually signed by the sole proprietor (or a general partner or a duly authorized corporate officer, as appropriate) and by the accountant, respectively.

Antimoney Laundering Regulations[22]

3.92 The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the Patriot Act) requires broker-dealers to implement certain recordkeeping and reporting requirements. They should also establish an antimoney laundering (AML) program, which, at a minimum, contains the following components: (1) development of internal policies, procedures, and controls; (2) designation of a compliance officer; (3) an ongoing employee training program; and (4) an independent audit function to test programs.

3.93 Broker-dealers are required to establish, document, and maintain a written customer identification program (CIP). This program should be appropriate for the firm's size and business, be part of the firm's AML compliance program, and, at a minimum, should contain the following 4 elements: (1) establishing identity verification procedures; (2) maintaining records related to CIP; (3) determining whether a customer appears on any designated list of terrorists or terrorist organizations; and (4) providing customers with notice that information is being obtained to verify their identities. The CIP rule provides that, under certain defined circumstances, broker-dealers may rely on the performance of another financial institution to fulfill some or all of the requirements of the broker-dealer's CIP.

3.94 Among other things, these rules require that firms independently test their AML programs. The independent tests should occur on an annual basis for most firms. Many broker-dealers are concerned about the independent testing requirement and its impact on their auditors' independence. It would be proper for the auditor of the broker-dealer to perform testing of an AML program if it is done in accordance with attestation standards. It can be performed as an agreed upon procedure, or an attestation of management assertions. However, if performed as a consulting service, such as generating work papers, reports for FINRA or New York Stock Exchange (NYSE) to review, the SEC staff believes this would be considered a management function, and therefore would impair the auditor's independence. Firms may use internal staff as long as they are independent from the AML program itself and have the knowledge they need to effectively evaluate a firm's AML system. However, some firms may find it more cost effective to use a qualified outside party. Training internal staff and establishing procedures to ensure their independence can be expensive. Some small firms have coordinated with other small firms to hire an outside auditor at a reduced group rate.[||||]

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[22] The SEC has available on its website an antimoney laundering (AML) source tool. It is a compilation of key AML laws, rules, and guidance applicable to broker dealers. The tool organizes the key AML compliance materials and provides related source information. It can be accessed at www.sec.gov/about/offices/ocie/amlsourcetool.htm.

[||||] The SEC approved a FINRA proposed rule change to adopt FINRA Rule 3310, *Anti-Money Laundering Compliance Program*, on September 10, 2009. This rule, effective January 1, 2010, is substantially the same as the former NASD Rule 3011. However, the rule, as adopted, eliminates the independent testing exception that was in the related NASD rule.

Reporting Requirements

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

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

- *Part I.* A monthly report of selected summarized financial and operational data, filed by broker-dealers that carry customer securities accounts or clear securities transactions. (Examining authorities may require other broker-dealers to file part I on a monthly basis.)
- *Part II*. A report of general-purpose financial information that presents the financial position and the results of operations, supplemental schedules, and operational data and is filed each calendar quarter by broker-dealers that file part I.
- *Part IIA*. A quarterly report of financial information that presents the financial position and the results of operations, supplemental schedules, and operational data, filed by broker-dealers that do not carry customer securities accounts or clear securities transactions.
- *Part IIB*. A quarterly report made by OTC derivatives dealers who register with the SEC under a limited regulatory structure, as discussed in paragraph 3.147 of this guide, that includes statements of financial condition and income, computation of net capital and net capital required, capital withdrawals, and other schedules of financial and operational data.
- *Part III*. A facing page required as part of all FOCUS filings that contains overall information regarding the filing.
- *Schedule I.* Annual supplementary schedules reflecting certain economic and statistical data of broker-dealers on a calendar-year basis.

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

3.98 SEC Rule 17a-5 defines *fiscal year* as the broker-dealer's fiscal year for reporting purposes; the fiscal year is not necessarily the same as the tax

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[##] FINRA Notice 10-12, *Guidance on FAS 167 for FOCUS Reporting*, provides information received from SEC staff regarding procedures for reporting adjustments on the FOCUS report resulting from an entity's adoption of Financial Accounting Standards Board (FASB) Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*. The notice is available on the FINRA website at www.finra.org/Industry/Regulation/Notices/2010/P120953.

year. For purposes of defining a time period such as fiscal or calendar quarter, the last Friday or last business day of such period is acceptable.

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

Consolidation of Subsidiaries

3.100 Appendix C of Rule 15c3-1 requires a broker-dealer to consolidate the financial accounts of any subsidiary or affiliate for which the broker-dealer has guaranteed, endorsed, or assumed the obligations or liabilities. (Guarantees of specific obligations should be reflected in the broker-dealer's capital computation by a single charge to total equity.) However, if the effect of consolidating any subsidiary or affiliate is to improve net capital or the net capital ratio computed pursuant to SEC Rule 15c3-1, the broker-dealer should obtain an opinion from legal counsel as of the date of the financial statements (such opinion should be renewed annually) that the net assets of the subsidiary can be liquidated and distributed to the broker-dealer within 30 calendar days. In no event can a broker-dealer rely on a consolidation of any subsidiary or affiliate to meet its minimum net capital requirement.

The Annual Audited Report

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

- Every member (with certain narrow exceptions, such as specialists who do not do business with customers, as well as option market makers on the Chicago Board Options Exchange) of a national securities exchange who transacts business in securities directly with or for persons other than members of national securities exchanges
- Every broker-dealer (other than a member) who transacts a business in securities through a medium of any member of a national securities exchange
- Every broker-dealer registered in accordance with Section 15 of the Securities Exchange Act of 1934
- OTC derivatives dealers registered pursuant to Section 15 of the Securities Exchange Act of 1934[23]

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

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

[23] Rule 17a-12, "Reports to Be Made by Certain OTC Derivatives Dealers," includes the requirements for audited annual financial statements of OTC derivatives dealers registered pursuant to Section 15 of the Securities Exchange Act of 1934 under a limited regulatory structure, as discussed in paragraph 3.147 of this guide.

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

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

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

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

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

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

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

3.108 According to FINRA rules,[24] the application for an extension should

a. state the reasons for the requested extension;

b. indicate that the inability to make a timely filing is due to circumstances beyond the control of the broker-dealer if such is the case, and describe briefly the nature of such circumstances;

c. indicate if the broker-dealer is in violation of SEC Rule 15c3-1 or 15c3-3 or has any significant financial or recordkeeping problems; and

d. contain an agreement to file the report on or before the date specified by the broker-dealer in the application.

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

a. The reasons for the extension request

b. Whether there is any indication of material inadequacies in the accounting system, the control procedures, or the procedures for safeguarding securities

c. Whether there is any indication that the condition of the broker-dealer's records is endangering its ability to supervise its registered representatives and their handling of customers' accounts

d. Whether there is any indication that the broker-dealer is in violation of the net capital requirements specified in SEC Rule 15c3-1 or the requirements of SEC Rule 15c3-3 or has any significant financial or recordkeeping problems

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

3.111 Similar financial statements should be filed with the SEC (for government securities broker-dealers) within 60 calendar days after the date of

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[24] The NASD manual is now part of the FINRA transitional rulebook. See footnote 10 in paragraph 3.04.

the financial statements and simultaneously with the CFTC (for broker-dealers that are also FCMs).

3.112 All annual audited financial statements that are filed with the SEC are treated as public documents unless the broker-dealer makes separate filings of the reports. If the broker-dealer requests confidential treatment of other than the statement of financial condition (not available for public inspection), the statement of financial condition is required to be bound separately from the balance of the statements. The balance of the annual audited financial statements must be bound separately or placed in a separate package. A facing page marked "Confidential Treatment Requested" should be completed and attached to these statements. The statement of financial condition should not be marked "confidential." The public and nonpublic portions of the financial statements must be filed separately in the format required in order for the nonpublic portion of the financial statements to be treated as such.[25]

3.113 The filing with the various exchanges of which the broker-dealer is a member should include both *(a)* the complete annual audited report filed with the SEC and the CFTC on a confidential basis and *(b)* the additional filing made with the SEC and CFTC as a public document.[26]

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

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

3.115 As a matter of administrative convenience, the FCM or IB may submit with its certified annual financial report an additional copy that has been marked "public" and contains only the information that is publicly available upon request under CFTC Regulation 1.10g. The CFTC will not, however,

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[25] See footnote 19 in paragraph 3.81.

[26] See footnote 19 in paragraph 3.81.

process any petitions for confidential treatment of any part of the audited or unaudited financial reports filed by FCMs and IBs. In accordance with the Freedom of Information Act, the Government in the Sunshine Act, and Parts 145 and 147 of CFTC regulations, all portions of such financial reports will be treated as nonpublic except for those portions specified as publicly available in Regulation 1.10g.

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

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

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

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

Filings Concurrent With the Annual Audited Report

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

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

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

3.121 The audit is to be made in accordance with generally accepted auditing standards and should include the following:

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

— The requirements for safeguarding securities (possession and control)

— The daily computations of the segregation and foreign set-aside requirements of the Commodity Exchange Act

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

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

Report to State Regulatory Agencies

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

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

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

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

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

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

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

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

Other Reports

Reports on Securities Investor Protection Corporation Assessment

3.131 Broker-dealers registered with the SEC, with some limited exceptions, are required to be members of the Securities Investor Protection Corporation (SIPC).[27] SIPC imposes an assessment upon members to maintain its fund and to repay any borrowings by SIPC. For a number of years, the assessment on members was a flat rate of $150.[***] In March 2009, SIPC determined that the SIPC fund balance would likely remain less than $1 billion for a period of 6 months or more. Therefore, beginning April 1, 2009, SIPC reinstituted an assessment rate of 1 quarter of 1 percent of each member's SIPC net operating revenues. SIPC assessment forms and payments are due semiannually based on the member's fiscal year end.[28]

3.132 Certain broker-dealers are excluded from membership in SIPC and therefore are not subject to SIPC assessment. The 2009 Form SIPC-3, *Certification of Exclusion From Membership*, notes that broker-dealers that effect transactions in security futures products only and those broker-dealers whose principal place of business (in the determination of SIPC) is outside the United States and its territories are excluded from membership. In addition, broker-dealers whose business is exclusively (1) the distribution of shares of registered open end investment companies or unit investment trusts, (2) the sale of variable annuities, (3) the business of insurance, or (4) the business of rendering investment advisory services to one or more registered investment companies or insurance company separate accounts are excluded from membership in SIPC.

3.133 SEC Rule 17a-5(e)(4) (the rule) requires that a registered broker-dealer file a report, covered by an independent accountants' report,

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[27] See the discussion at paragraph 1.47 for more information on Securities Investor Protection Corporation (SIPC).

[***] The Dodd-Frank Act amended the Securities Investor Protection Act in several areas. Two areas pertain to the SIPC assessment imposed on broker-dealers. See the preface for more information on the SIPC amendments. Also see the SIPC website for the SIPC-7 form, as revised in July 2010 for the abovementioned amendments.

[28] SIPC assessment forms and instructions will be mailed to members semiannually and should be filed in accordance with the member's fiscal year. See the SIPC website www.sipc.org/members/members.cfm for more information.

supplemental to the annual audited statement report concerning the status of the broker-dealer's membership in SIPC. The supplemental report should cover the SIPC annual general assessment reconciliation or exclusion from membership forms, and should include certain procedures specified in Section (iii) of the rule. This report requirement did not apply while the SIPC assessment rate was the minimum assessment of $150. However, with the assessment rate being restored to 1 quarter of 1 percent of a member's SIPC net operating revenues, the reports will be required. Appendix G, "Independent Accountants' Report on Applying Agreed-Upon Procedures Related to an Entity's SIPC Assessment Reconciliation," of this guide provides an illustrative example of the agreed upon procedures report required for those broker-dealers subject to the SIPC assessment.[29] In addition, this report is available at the Stockbrokerage and Investment Banking expert panel section of the AICPA website at www.aicpa.org/INTERESTAREAS/ACCOUNTINGANDAUDITING/COMMUNITY/INVESTMENTBANKING/Pages/StockbrokerageInvestmentBanking.aspx.

Reports on Agreed-Upon Procedures for Distributions

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

Additional Requirements for Registered Investment Advisers

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

3.136 A broker-dealer who is also a registered investment adviser (also known as a *dual registered entity*) may be subject to significant requirements as a result of amendments to Rule 206(4)-2 of the Investment Advisers Act of 1940 (the rule). In December 2009, the SEC adopted rules designed to substantially increase the protections for investor funds and securities of which an investment adviser registered with the SEC has custody. The rule includes a revision of an existing surprise examination requirement and introduces an internal control examination requirement.[30,31] The effective date of the amendment is

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[29] At the issue date of this guide, an illustration of an independent accountants' report required under SEC Rule 17a-5(e)(4) that covers an entity's exclusion from SIPC membership was being developed. When the illustrative report is available, it will be posted on the AICPA website at the Stockbrokerage and Investment Banking expert panel section at www.aicpa.org/INTERESTAREAS/ACCOUNTINGANDAUDITING/COMMUNITY/INVESTMENTBANKING/Pages/StockbrokerageInvestmentBanking.aspx.

[30] Broker-dealers who are dual registered entities ordinarily would be subject to both the surprise examination and internal control report because (being the same entity) they could not be considered operationally independent.

[31] Footnote 95 of SEC Release No. IA-2968, *Custody of Funds or Securities of Clients by Investment Advisers*, notes that in meeting certain of the requirements, the independent public accountant can incorporate its own work performed pursuant to other regulatory requirements, such as requirements under Rule 17a-13 and 17a-5 of the Exchange Act.

March 12, 2010, subject to certain exceptions. The following discussion is a summary of some of the provisions of the amendment. For complete information, readers are encouraged to review the full text of SEC Release No. IA-2968, *Custody of Funds or Securities of Clients by Investment Advisers*, and the related Interpretive Release No. IA-2969, *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*.[†††] Additionally, the SEC has released frequently asked questions about the custody rule, which can be located at www.sec.gov/divisions/investment/custody_faq_030510.htm.

3.137 As amended, paragraph (a)(4) of Rule 206(4)-2 under the Investment Advisers Act of 1940 requires that all registered investment advisers (or an investment adviser required to register) who have custody of client funds or securities, as defined, have an independent public accountant that is registered with and subject to inspection by the Public Company Accounting Oversight Board (PCAOB), conduct an examination on a surprise basis once every calendar year.[32] This surprise examination is conducted under AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1). The independent public accountant must also file a certificate on Form ADV-E with the SEC within 120 days of the time chosen for the surprise examination by the independent public accountant, stating that it has examined the funds and securities and describing the nature and extent of the examination.[33]

3.138 The rule defines *custody* to mean an investment adviser, or its related person, holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them.[34] Custody includes

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

[†††] SEC release No. IA-2968, *Custody of Funds or Securities of Clients by Investment Advisers*, is available on the SEC website at http://sec.gov/rules/final/2009/ia-2968.pdf. SEC release No. IA 2969, *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*, is available at http://sec.gov/rules/interp/2009/ia-2969.pdf.

[32] The surprise examination requirement applies even when assets are maintained by an independent qualified custodian.

[33] The independent accountant, upon finding any material discrepancies during the course of the examination, should notify the SEC within one business day of the finding, by means of a facsimile transmission or electronic mail, followed by first class mail, directed to the attention of the "Director of the Office of Compliance Inspections and Examinations." See Rule 206(4)-2(a)(4)(ii) under the Investment Advisers Act of 1940.

[34] Rule 206(4)-2(d)(2) provides that an adviser will not be deemed to have custody of client assets held with a qualified custodian that is a related person of the adviser if the adviser does not provide advice with respect to such assets.

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

3.140 Rule 206(4)-2 requires that a qualified custodian maintain client funds and securities in a separate account for each client under that client's name or in accounts that contain only the clients' funds and securities, under the adviser's name as agent or trustee for the clients. Notice to clients must be provided when an account is opened (and following any changes) with a qualified custodian on their behalf, which details the qualified custodian's name, address, and the manner in which the funds or securities are maintained. The investment adviser must also have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of the investment advisers' clients for which it maintains funds or securities.[35]

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

3.142 This requirement could be satisfied with a Type 2 SAS No. 70[‡‡‡] report or an examination on internal control conducted in accordance with AT section 601. In addition, as explained in question XIII.3 of the SEC's "Staff

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

[‡‡‡] The guidance located in AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1), related to the audit of the financial statements of entities that outsource work to a service organization and for those who report on controls at service organizations, is being revised and relocated. The requirements for auditing the financial statements of entities that use service organizations will be located in a new Statement on Auditing Standards (SAS), *Audit Considerations Related to an Entity Using a Service Organization*. This guidance will be located in AU section 324 and will be effective on the same date (to be determined) as the other clarified SASs. The requirements for reporting on controls at a service organization have been replaced by Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, vol. 1, AT sec. 801), which was issued in April 2010. The guidance in SSAE No. 16 is effective for periods ending on or after June 15, 2011.

Responses to Questions About the Custody Rule," a report under AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1), would also be acceptable. This internal control report must include an opinion as to whether controls have been placed in operation as of a specific date, and are suitably designed and are operating effectively to meet control objectives relating to custodial services, including the safeguarding of funds and securities held by either the investment adviser or its related person on behalf of the advisory clients during the year. The accountant must also verify that the funds and securities are reconciled to a custodian (for example, the Depository Trust and Clearing Corporation) other than the investment adviser or its related person. The accountant's tests of the custodian's reconciliation should include either direct confirmation, on a test basis, with unaffiliated custodians or other procedures designed to verify that the data used in the reconciliations performed by the qualified custodian is obtained from unaffiliated custodians and is unaltered.

3.143 Refer to the discussion beginning at paragraph 11.18 in the 2010 edition of the AICPA Audit and Accounting Guide *Investment Companies* for more information on the amendments to the Investment Advisers Act of 1940 and for guidance on the reports required to be filed by independent auditors of broker-dealers that are registered as investment advisers under the act.[||||||]

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

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

Commodities FCMs[****]

3.145 The primary sections of the CE Act and CFTC regulations are applicable to FCMs as follows:

- Section 4d-a-2, "Segregation requirements"
- Section 4f-b, "Minimum financial requirements"

[||||||] The illustrative report on examinations of securities pursuant to Rule 206(4)-2 is available in the 2010 edition of the *Investment Companies* guide and on the AICPA website. The illustrative example of the required internal control report on management's assertion regarding controls at a custodian has now been finalized and posted on the AICPA website in the Industry Expert Panels—Investment Company section at www.aicpa.org/INTERESTAREAS/ACCOUNTINGANDAUDITING/COMMUNITY/INVESTMENTCOMPANIES/Pages/InvestmentCompanies.aspx.

[###] U.S. Commodity Futures Trading Commission (CFTC) staff is developing, in conjunction with industry and independent auditors, an "Agreed Upon Procedures" report for the segregation and secured amount schedules included in an FCM's annual audited financial report. The report is designed to provide greater assurance that FCMs are complying with the regulatory requirements surrounding the segregation and secured computations that are included in the annual report.

[****] In January 2010, CFTC proposed to adopt a comprehensive scheme that would put in place requirements for, among other things, registration, disclosure, recordkeeping, financial reporting, minimum capital, and other operational standards requiring the registration of counterparties offering retail foreign currency contracts as FCMs or retail foreign exchange dealers, a new category of registrant. However, SEC-registered brokers or dealers remain able to serve as counterparties in such transactions under the oversight of their primary regulators.

The comment period closed and the CFTC staff is reviewing the numerous comment letters. For current information on the status of the proposal, readers should refer to the CFTC website www.cftc.gov under the Law and Regulation tab.

- Part 1 (17 CFR Ch 1 Part 1—General Regulations Under the Commodity Exchange Act) including the following:
  - — Regulation 1.10, "Financial reports of futures commission merchants and introducing brokers"
  - — Regulation 1.12, "Maintenance of minimum financial requirements by futures commission merchants and introducing brokers"
  - — Regulation 1.14, "Risk assessment recordkeeping requirements for futures commission merchants"
  - — Regulation 1.15, "Risk assessment reporting requirements for futures commission merchants"
  - — Regulation 1.16, "Qualifications and reports of accountants"
  - — Regulation 1.17, "Minimum financial requirements for futures commission merchants and introducing brokers" (also see NFA financial requirements)
  - — Regulation 1.18, "Records for and relating to financial reporting and monthly computation by futures commission merchants and introducing brokers"
  - — Regulations 1.20–1.30, collectively titled "Customers' Money, Securities, and Property" and 1.49, "Denomination of customer funds and location of depositories"
  - — Regulations 1.31–1.37, collectively titled "Recordkeeping"
- Part 30 (17 CFR Ch 1 Part 30—Foreign Futures and Foreign Options Transactions), including Regulation 30.7, *Treatment of foreign futures or foreign options secured amount*
- Part 32 (17 CFR Ch 1 Part 32), Regulation of Commodity Option Transactions

Government Securities Broker-Dealers

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

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

OTC Derivatives Dealers

3.147 An alternative regulatory framework has been created for OTC derivatives dealers. The rules establish a special class of broker-dealers who may choose to register with the SEC under a limited regulatory structure. An OTC derivatives dealer's securities activities are limited to (*a*) engaging in dealer activities in "eligible OTC derivative instruments," as defined in new Rule 3b-13, that are securities; (*b*) issuing and reacquiring securities that are issued by the dealer, including warrants or securities, hybrid securities and

structured notes; (*c*) engaging in cash management securities activities as set out in new Rule 3b-14; (*d*) engaging in "ancillary portfolio management securities activities" as defined in new Rule 3b-15; (*e*) engaging in such other securities activities that the SEC designates by order.

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

Annual Compliance Certification

3.149 FINRA Rule 3130, "Annual Certification of Compliance and Supervisory Processes," requires members to (1) designate a chief compliance officer (CCO) and (2) have the CEO, or equivalent officer, certify annually that the member has in place processes to establish, maintain, review, test, and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable FINRA rules, MSRB rules, and federal securities laws and regulations, and that the CEO has conducted 1 or more meetings with the CCO in the preceding 12 months to discuss such processes. Additional information is available on the FINRA website at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6286.

Chapter 4

Financial Statement Presentation and Classification

Introduction

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

4.02 In addition to the disclosures shown in exhibit 4-8, "Notes to Consolidated Financial Statements," at the end of this chapter, there may be certain other disclosures required under Regulation S-X of the SEC for those companies that are registered under Section 12(b) or 12(g) of the Securities Exchange Act of 1934. Regulation S-X does not apply to the financial statements filed with the SEC under Rule 17a-5, but certain independence requirements of Regulation S-X do apply.[1]

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

4.04 Over-the-counter (OTC) derivatives dealers registered pursuant to Section 15 of the Securities Exchange Act of 1934 under an alternative regulatory framework as discussed in paragraph 3.147 of this guide, are subject

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[1] In January 2003, the Securities and Exchange Commission (SEC) adopted amendments to its requirements regarding auditor independence to enhance the independence of accountants who audit and review financial statements and prepare attestation reports filed with the SEC. In August 2003, the SEC's Office of the Chief Accountant provided responses to 35 frequently asked questions regarding the application of these rules. This list of questions was revised in December 2004. Question no. 1, in the "Broker-Dealer and Investment Advisers" section, indicates that the scope of services provisions of Sarbanes-Oxley extend to auditors of privately held broker-dealers. Accordingly, auditors of privately held broker-dealers are restricted from performing those services specifically excluded by Sarbanes-Oxley and are expected to comply with all other SEC independence rules, including those that prohibit bookkeeping and the preparation of financial statements for privately held broker-dealers. However, as indicated by the response to the previously mentioned question, the auditor rotation rules do not apply to auditors of private broker-dealers. SEC answers to frequently asked questions regarding the independence rules can be found at www.sec.gov/info/accountants/ocafaqaudind121304.htm. Independence standards of the Public Company Accounting Oversight Board (PCAOB) do not currently apply to nonissuer broker-dealers. However, as a result of provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the PCAOB may extend these standards or issue specific standards under its oversight authority of audits of broker-dealers. See the preface for more information.

to SEC Rule 17a-12. Rule 17a-5 states that an OTC derivatives dealer may comply with Rule 17a-5 by complying with the provisions of Rule 17a-12. The rules governing reporting for OTC derivatives dealers remain substantially the same as for fully regulated broker-dealers. However, they have been tailored to the business of OTC derivatives dealers. SEC Rule 17a-12 contains guidance on reports to be made by OTC derivatives dealers.

4.05 Some of the unique attributes of the financial statements and the accounts or captions appearing therein, as they relate to broker-dealers, are discussed in the following sections. In addition to the information in this chapter, a discussion of a variety of accounting issues that are important to broker-dealers, including a discussion of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, and FASB ASC 825, *Financial Instruments*, can be found in chapter 7, "Accounting Standards."

Financial Statements

Statement of Financial Condition

4.06 The audited statement of financial condition should be in a format and on a basis consistent with the totals reported on the statement of financial condition contained in part II or part IIA of the FOCUS report, as filed by the broker-dealer. This presentation should conform with U.S. GAAP. See paragraph 4.09 for a discussion on subordinated liabilities and ownership equity.

4.07 However, as discussed in FASB ASC 940-20-45-1, current and noncurrent classifications are ordinarily not presented in the statement of financial condition because such a distinction normally has little meaning for brokers and dealers.

4.08 The statement of financial condition should disclose on the face of the statement or in a note the components of ownership equity (for example, preferred stock, common stock, additional paid-in capital, and retained earnings).

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

Statement of Income or Operations

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

Statement of Cash Flows

4.11 As noted in FASB ASC 230-10-15-3, a business entity that provides a set of financial statements that presents both the statement of financial

condition and the statement of income or operations should also provide a statement of cash flows for each period for which a statement of income or operations is provided. FASB ASC 940-320-45-7 states that broker-dealers should report their trading securities activities in the operating section of the statement of cash flows.

4.12 The presentation described in the previous paragraph is appropriate for the securities industry because, unlike other industries, a broker-dealer's business is to acquire and finance securities and other financial instruments.

Statement of Changes in Ownership Equity

4.13 The statement of changes in ownership equity should be in a format that is consistent with the statement contained in part II or part IIA of the FOCUS report. This statement is required whether the reporting broker-dealer is a corporation, limited liability company, partnership, or sole proprietorship. It should disclose the principal changes in the equity accounts of the broker-dealer during the periods for which a statement of income or operations is presented.

4.14 FASB ASC 480, *Distinguishing Liabilities from Equity*, provides guidance regarding certain instruments that should not be considered equity, and instead should be considered a liability and be classified as such (with changes reflected as a component of the income statement). Examples include certain mandatorily redeemable preferred and common stock, general partner buy/sell arrangements and other similar arrangements. (Please refer to paragraphs 7.98–.100 for more information.) Separate classification on the face of the financial statements and disclosure in the footnotes should be made for any "redeemable" forms of equity. (See paragraphs 1–2 of FASB ASC 480-10-45 and paragraphs 1–2 and 4 of FASB ASC 480-10-50 for additional guidance.)

Statement of Changes in Liabilities Subordinated to Claims of General Creditors

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

Consolidation of Subsidiaries

4.16 Annual audited financial statements of a company and its subsidiaries that are presented in conformity with U.S. GAAP are presented on a consolidated basis in accordance with FASB ASC 810, *Consolidation*, FASB ASC 860, *Transfers and Servicing* (which provides guidance for consolidation of qualifying special purpose entities),[*] and FASB ASC 805, *Business Combinations*. However, audited financial statements filed pursuant to part II or part IIA of the FOCUS report may have different consolidation requirements. If the statement of financial condition, filed on part II or part IIA of the FOCUS report, is not on a consolidated basis, or if consolidation on part II or

[*] Financial Accounting Standards Board (FASB) Statement No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, eliminates the concept of special purpose entities upon its effective date (the first annual reporting period that begins after November 15, 2009). See footnote † to the heading before paragraph 4.43 for more information.

part IIA of the FOCUS Report is on a "one line" (equity) basis, it may differ from the statement reported on by the independent auditor. The SEC requires that such differences, if material, be disclosed in a note to the audited financial statements or included as supplementary information.

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

Supplementary Schedules

4.18 Certain supplementary schedules are required to be filed with the financial statements. These supplementary schedules should be presented in the format that presents the relevant details required by SEC and Commodity Futures Trading Commission (CFTC) rules and should be filed as a part of the FOCUS report. The independent auditors' report is required to cover these schedules, which should be filed as of the audit date. See exhibit 4-9 for illustrative examples of these schedules.

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

4.19 This schedule shows the computation of the net capital and required net capital of the broker-dealer. A reconciliation is required if material differences exist between the computation reported on by the independent auditor and the broker-dealer's original unaudited filing of part II or part IIA of the FOCUS report.[2] If no material differences exist, a statement to that effect should be made in the schedule.

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

4.20 This schedule shows the computation of the required deposit in special reserve bank accounts for the exclusive benefit of customers. If the broker-dealer is required to make computations of required deposits in special reserve bank accounts pursuant to agreements under proprietary accounts of introducing broker arrangements, a separate schedule of such computation should be presented. A reconciliation is required if material differences exist between the computation(s) reported on by the independent auditor and the computation(s) filed previously by the broker-dealer in the original unaudited FOCUS report.[3] If no material differences exist, a statement to that effect should be made in the schedule(s).

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[2] As permitted under the "SEC Letter to New York Stock Exchange (NYSE)" dated April 24, 1987, if a broker-dealer files an amended Financial and Operational Combined Uniform Single (FOCUS) report that contains the reconciliation and explanation of material differences between the amended report and the original report, the audit report may be reconciled with the amended FOCUS report and would include a statement about whether any material differences exist between the amended FOCUS report and the audited financial statements.

[3] See footnote 2 in paragraph 4.19.

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

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

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

4.22 The segregation schedule shows the computation of the amount of funds that should be segregated for customers trading on U.S. commodity exchanges and the total funds segregated by the broker-dealer to meet those requirements. In addition, a secured amount schedule, which shows the computation of funds required to be set aside in separate accounts for customers trading on non-U.S. commodity exchanges and the amount of funds in such separate accounts should be included in the filing. A reconciliation is required if material differences exist between the computation(s) reported on by the independent auditor and the computation(s) filed previously by the broker-dealer in the original unaudited FOCUS report.[4] If no material differences exist, a statement to that effect should be made in the schedule(s).

Statement of Financial Condition Account Descriptions

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

Cash

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

Memberships in Exchanges

4.25 As discussed in FASB ASC 940-340-05-1, exchange memberships provide the broker-dealer with the right to do business on the exchanges of which the broker-dealer is a member. Some exchange memberships also represent an ownership interest in the exchange. Due to the demutualization of many exchanges, membership may not be aligned with ownership in the exchange

[4] See footnote 2 in paragraph 4.19.

as trading privileges are disaggregated from ownership. Many broker-dealers have memberships in several exchanges and have more than one membership in any particular exchange. Memberships are usually registered in the names of individuals who are affiliated with the broker-dealer. FASB ASC 940-340-25-2 states that a membership held in the name of an individual is considered to be an asset of the broker-dealer if it is held by the broker-dealer under an agreement (such as an ABC agreement)[5] that would require the member, upon leaving the broker-dealer, to do one of the following:

a. Pay the member organization the amount necessary to purchase another membership (if the named individual wished to retain the membership)

b. Sell the membership and pay the proceeds over to the member organization

c. Transfer the membership for a nominal consideration to a person designated by the member organization and satisfactory to the exchange

4.26 As noted in FASB ASC 940-340-25-1, a membership may be considered to be an asset of the broker-dealer if its use has been contributed to the broker-dealer under a formal or informal subordination agreement.

Receivables From and Payables to Broker-Dealers and Clearing Organizations

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

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

4.29 *Fail-to-deliver.* According to FASB ASC 940-20-25-4, a broker-dealer that sells securities, either for its own account or for a customer's account, but does not deliver the securities on the settlement date should record the fail-to-deliver as an asset in the receivable account due from broker-dealers. FASB ASC 940-20-30-1 explains that a fail-to-deliver asset should be measured initially at the selling price, including any accrued interest.

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[5] The FASB *Accounting Standards Codification* (ASC) glossary defines an ABC agreement as an agreement between a brokerage firm and one of its employees spelling out the firm's rights when it purchases a NYSE (or similar exchange) membership for the employee. Only individuals can be members of the NYSE (and certain other exchanges), and it is common practice for a firm to finance the purchase of a membership, or seat, by one of its employees. The NYSE approved ABC agreement contains the following provisions regarding the future disposition of the seat: (1) the employee may retain the membership and buy another seat for an individual designated by the firm, (2) the employee may sell the seat and give the proceeds to the firm, or (3) the employee may transfer the seat to another employee of the firm.

4.30 The fail-to-deliver asset discussed in the previous paragraph will be collected upon delivery of the securities.

4.31 *Fail-to-receive.* FASB ASC 940-20-25-5 notes that a broker-dealer that purchases securities, either for its own account or for a customer's account, but does not receive the securities on the settlement date should record the fail-to-receive as a liability to the selling broker-dealer. FASB ASC 940-20-30-2 explains that a fail-to-receive liability should be measured initially at the amount of money representing the purchase price of the securities, including any accrued interest.

4.32 The fail-to-receive liability discussed in the previous paragraph is paid when the securities are received by the purchasing broker-dealer.

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

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

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

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

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

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

4.38 FASB ASC 210-20-05-1 states that it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except if a right of setoff exists.

4.39 The FASB ASC glossary defines *right of setoff* as a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor. FASB ASC 210-20-45-1 provides that a right of setoff exists when all of the following conditions are met:

a. Each of two parties owes the other determinable amounts.

b. The reporting party has the right to set off the amount owed with the amount owed by the other party.

c. The reporting party intends to set off.

d. The right of setoff is enforceable at law.

4.40 FASB ASC 940-405-55-1 states that securities borrowed and securities loaned transactions that do not have explicit settlement dates do not meet the requirement in FASB ASC 210-20-45-1 for a right of setoff. Balances arising from securities borrowed and loaned transactions that are accounted for as secured borrowings are presented gross on the statement of financial condition because they do not have explicit settlement dates.

4.41 FASB ASC 860 provides specific criteria for determining whether a securities lending transaction is to be accounted for as a sale or as a secured borrowing and provides an illustration of the latter. See also paragraphs 7.66–.74 for further discussion of secured borrowings. FASB ASC 210-20-45-9 discusses the nature of support required for an assertion in financial statements that a right of setoff is enforceable at law.

Receivables From and Payables to Customers

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

Securities Sold Under Agreements to Repurchase[†]

4.43 A repurchase transaction (repo) is, in its simplest form, a sale of a security coupled with an agreement by the seller to repurchase the same or

[†] Accounting Standards Update (ASU) No. 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*, amends FASB ASC for the issuance of FASB Statement No. 166. The amendments in this ASU improve financial reporting by eliminating the exceptions for qualifying special-purpose entities from the consolidation guidance and the exception that permitted sale accounting for certain mortgage securitizations when a transferor has not surrendered control over the transferred financial assets. In addition, the amendments require enhanced disclosures about the risks that a transferor continues to be exposed to because of its continuing involvement in transferred financial assets. Comparability and consistency in accounting for transferred financial assets will also be improved through clarifications of the requirements for isolation and limitations on portions of financial assets that are eligible for sale accounting. This guidance is effective for the first annual reporting period that begins after November 15, 2009. This guide will be updated for this guidance in a future edition.

substantially the same security[6] from the same counterparty at a fixed or determinable price (generally the original sale price plus accrued interest) within a fixed or variable time period. FASB ASC 860 provides specific criteria for determining whether repos should be accounted for as sales or as secured borrowings.

Securities Purchased Under Agreements to Resell

4.44 A reverse repurchase agreement (*reverse repo* or *resale*) is, in its simplest form, the purchase of a security at a specified price with an agreement to sell the same or substantially the same security to the same counterparty at a fixed or determinable price at a future date. Repos and reverse repos that are accounted for as secured borrowings should be recorded as both assets and liabilities on the statement of financial condition and may be netted if the conditions of FASB ASC 210-20-45-11 are met.

Securities Owned and Securities Sold, Not Yet Purchased

4.45 According to FASB ASC 940-320-45-2, proprietary securities transactions entered into by the broker-dealer for trading or investment purposes are included in "Securities Owned" and "Securities Sold, Not Yet Purchased."

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

4.47 FASB ASC 940-320-30-2 and FASB ASC 940-320-35-1 state that security positions resulting from proprietary trading are measured initially and subsequently at fair value. According to FASB ASC 940-320-35-2, any unrealized gains or losses resulting from marking these to the fair value are included in profit or loss. As noted in FASB ASC 940-320-45-4, the fair value of fixed-income securities owned that were purchased at a discount or premium is composed of accreted interest income, changes in the fair value of the securities, or both. Consideration should be given to reporting these components separately as interest income and trading gains and losses, respectively.

4.48 See chapter 7 for a more complete discussion of fair value measurement under FASB ASC 820.

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

4.50 Per FASB ASC 940-20-50-1, broker-dealers acting as principals in underwriting and when-issued contracts have contractual commitments. Disclosure should be made of such commitments. As noted in FASB ASC 940-20-45-2,

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[6] The meaning of *substantially the same* is explained in FASB ASC 860-10-40-24(a).

the broker-dealer's share (assuming such share is not merely contingent) in underwriting or joint accounts with other broker-dealers for issued securities should be included with its trading accounts (amounts receivable from or payable to broker-dealer).

Bank Loans

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

4.52 FASB ASC 860-30-25 addresses the accounting for collateral and requires, in some cases, that a debtor reclassify an asset pledged as collateral to indicate that it is encumbered. The standards for accounting for noncash collateral in FASB ASC 860-30-25-5 require that the debtor reclassify noncash collateral that the secured party has the right by contract or custom to sell or repledge. Cash "collateral," sometimes used, for example, in securities lending transactions, should be derecognized by the payer and recognized by the recipient, not as collateral, but rather as proceeds of either a sale or a borrowing. FASB ASC 860-30-50 provides guidance on required disclosures for collateral.

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

Commitments, Contingencies, and Guarantees

4.54 FASB ASC 460, *Guarantees*, discusses several transactions that may be interpreted to be a guarantee, which may require specific recognition and measurement within the financial statements. Examples include a parent's guarantee of a subsidiary's debt, indemnifications to service providers or counterparties, certain written options and certain credit default swaps. This topic elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of certain guarantees, a liability for the fair value of the obligation undertaken in issuing the guarantee. FASB ASC 460-10-25-1 lists the types of guarantees that are not subject to its initial recognition and initial measurement provisions, but are subject to its disclosure requirements.

Subordinated Borrowings

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

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

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

4.58 The lender actually retains ownership of the collateral, benefiting from increases, and bearing the risk for decreases, in its value. Securities pledged as collateral should be fully paid and be in bearer form or registered in the name of the broker-dealer or its custodian, which allows the securities to be used by the broker-dealer. The lender may withdraw any excess collateral or substitute cash or other securities as collateral. The securities received as collateral and cash, if any, would be recorded in a secured demand note account similar to a customer account. (Also see paragraph 4.52, which discusses the financial reporting treatment of collateral.)

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

Income Statement Account Descriptions

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

- Commission income
- Interest income and expense
- Dividend income and expense
- Principal transactions
- Underwriting income or loss
- Management and investment advisory income
- Floor brokerage

- Exchange fees
- Occupancy
- Employee compensation and benefits
- Communications and data processing

Commission Income

4.61 FASB ASC 940-20-05-3 explains that acting as an agent, a broker-dealer may buy and sell securities on behalf of its customers. In return for such services, the broker-dealer charges a commission. Each time a customer enters into a buy or sell transaction, a commission is earned by the broker-dealer for its selling and administrative efforts. As noted in FASB ASC 940-20-25-2, for securities purchased, the commission is recorded as a receivable from customers; for securities sold, it is recorded as reductions in the payable to customers.

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

Interest Income and Expense

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

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

4.64 Interest expense typically arises from the following:

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

Dividend Income and Expense

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

Trading Gains and Losses (Principal Transactions)

4.66 As noted in FASB ASC 940-320-05-3, a broker-dealer may buy and sell securities for its own account. FASB ASC 940-320-35-3 states that the profit or loss is measured by the difference between the acquisition cost and the selling price or fair value. According to FASB ASC 940-320-45-5, trading gains and losses (also referred to as principal transactions in industry practice), which are composed of both realized and unrealized gains and losses, are generally presented net.

Underwriting Income or Loss

4.67 FASB ASC 940-605-25-1 describes how a broker-dealer may underwrite a security offering by contracting to buy the issue either at a fixed price or a price based on selling the offering on a best-effort basis. Paragraphs 2–4 of FASB ASC 940-605-25 provide guidance on the timing of recognition of such revenue. The difference between the price paid by the public and the contract price less certain direct related expenses represents the underwriting income or loss.

Management and Investment Advisory Income

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

Floor Brokerage

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

Exchange Fees

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

Occupancy

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

Employee Compensation and Benefits

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

- Commission revenue from agency trades
- Fee revenue from assets managed
- Selling concessions from underwriting sales
- Sales credits or trading allowances from principal transactions

4.73 Employee compensation also includes employee salaries, bonuses, payroll taxes, and employee benefits. These expenses are not significantly different for broker-dealers than for other industries, except that at broker-dealers, bonuses usually represent a greater percentage of an individual's total compensation. Such compensation may be discretionary or nondiscretionary, and proper timing of recognition may involve judgment. In the event account executives or employees of a broker-dealer are compensated with equity of the broker-dealer or a related entity, FASB ASC 718, *Compensation—Stock Compensation*,[‡] should be referred to for guidance. This topic generally requires companies to recognize the value of employee stock options and similar awards as compensation expense over the requisite service period (usually the vesting period).

Communications and Data Processing

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

Disclosures

Disclosures of Certain Significant Risks and Uncertainties

4.75 FASB ASC 275, *Risks and Uncertainties*, requires entities to include in their financial statements disclosures about risks and uncertainties existing as of the date of the financial statements. Two of the areas of disclosure are (*a*) the nature of their operations and (*b*) the use of estimates in the preparation

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[‡] ASU No. 2010-13, *Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades—a consensus of the FASB Emerging Issues Task Force*, clarifies that a share-based payment award with an exercise price denominated in the currency of a market in which a substantial portion of the entity's equity securities trades should not be considered to contain a condition that is not a market, performance, or service condition. Therefore, an entity would not classify such an award as a liability if it otherwise qualifies as equity. The amendments are effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2010.

of their financial statements. Following are illustrations of the application of these disclosure requirements by a broker-dealer:

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

4.76 If specified disclosure criteria are met, FASB ASC 275 also requires entities to include in their financial statements disclosures about (*a*) certain significant estimates and (*b*) current vulnerability due to certain concentrations. Following is a discussion of the application of FASB ASC 275 by an entity to exemplify events and circumstances that meet the disclosure criteria.

4.77 *Certain significant estimates*. Paragraphs 7–8 of FASB ASC 275-10-50 require disclosure regarding estimates used in the determination of the carrying amounts of assets or liabilities, or disclosure of gain or loss contingencies if known information available prior to issuance of the financial statements indicates that both of the following criteria are met:

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

b. The effect of the change would be material to the financial statements.

4.78 FASB ASC 275-10-50-9 states that the disclosure should indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term. If the estimate involves a loss contingency covered by FASB ASC 450-20, the disclosure should also include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.[7]

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[7] Paragraphs 3–4 of FASB ASC 450-20-50 state that disclosure of the contingency should be made if there is at least a reasonable possibility that a loss or an additional loss may have been incurred and either of the following conditions exists:

a. An accrual is not made for a loss contingency because any of the conditions in FASB ASC 450-20-25-2 are not met

b. An exposure to loss exists in excess of the amount accrued pursuant to the provisions of FASB ASC 450-20-30-1

Such disclosure should include the nature of the contingency and an estimate of the possible loss or range of loss or state that such an estimate cannot be made.

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

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

4.80 FASB ASC 275-10-50-15 gives examples of assets and liabilities and related revenues and expenses, and of disclosure of gain or loss contingencies included in financial statements that, based on facts and circumstances existing at the date of the financial statements, may be based on estimates that are particularly sensitive to change in the near term.

4.81 Besides valuations of securities made by management, examples of similar estimates often included in broker-dealers' financial statements include the following:

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

4.82 *Current vulnerability due to certain concentrations*. FASB ASC 275-10-50-16 requires entities to disclose the concentrations described in FASB ASC 275-10-50-18 if, based on information known to management prior to issuance of the financial statements, all of the following criteria are met:

a. The concentration exists at the date of the financial statements.

b. The concentration makes the entity vulnerable to the risk of a near-term severe impact.

c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

4.83 FASB ASC 275-10-50-18 states that concentrations, including known group concentrations, described in the following list require disclosure if they meet the criteria of FASB ASC 275-10-50-16. (Group concentrations exist if a number of counterparties or items that have similar economic characteristics collectively expose the reporting entity to a particular kind of risk.) Some concentrations may fall into more than one of the following categories:

a. *Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor*. The potential for the severe impact can result, for example, from total or partial loss of the business relationship. For purposes of this topic, it is always considered at least reasonably possible that any customer will be lost in the near term.

b. *Concentrations in revenue from particular products, services, or fund-raising events.* The potential for the severe impact can result, for example, from volume or price changes or the loss of patent protection for the particular source of revenue.

c. *Concentrations in the available sources of supply of materials, labor, or services, or of licenses or other rights used in the entity's*

operations. The potential for the severe impact can result, for example, from changes in the availability to the entity of a resource or a right.

d. Concentrations in the market or geographic area in which an entity conducts its operations. The potential for the severe impact can result, for example, from the negative effects of the economic and political forces within the market or geographic area. For purposes of this topic, it is always considered at least reasonably possible that operations located outside an entity's home country will be disrupted in the near term.

4.84 Examples of concentrations found at a broker-dealer that could meet the criteria requiring disclosure as described in this topic include a significant portion of revenue that is earned from the following:

- Bond underwritings to a particular municipality
- A limited number of customers

Disclosures About Derivative Instruments[8]

4.85 Derivative instruments are subject to many disclosure requirements, and those requirements may be located in a number of different FASB ASC topics. FASB ASC 815, *Derivatives and Hedging*, provides guidance on disclosure requirements for derivative instruments. Additional disclosure requirements for derivative instruments may be found at FASB ASC 460, FASB ASC 820, and FASB ASC 825. FASB ASC 825-10-50 addresses the incremental disclosure provisions about fair value of financial instruments, concentrations of credit risk of all financial instruments and market risk of all financial instruments. See chapter 7 for information on disclosures required under FASB ASC 820.

4.86 FASB ASC 815-10-50-1 states that an entity with derivative instruments should disclose information to enable users of the financial statements to understand all of the following:

- How and why the entity uses derivative instruments
- How derivative instruments and related hedged items are accounted for
- How derivative instruments and related hedged items affect the entity's financial position, financial performance, and cash flows

4.87 For every annual and interim reporting period for which a statement of financial position and statement of financial performance are presented, FASB ASC 815-10-50-1A states that the entity that holds or issues derivatives instruments should disclose the following:

- Its objectives for holding or issuing those instruments
- The context needed to understand those objectives
- Its strategies for achieving those objectives
- Information that would enable users of its financial statements to understand the volume of activity in those instruments

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[8] For more information on FASB ASC 815, *Derivatives and Hedging*, see chapter 7, "Accounting Standards," in this guide.

FASB ASC 815-10-50 provides more information as to the detail that should be disclosed for a particular situation and the form the disclosure should take (tabular or nontabular format). Additional guidance regarding disclosures may also be found at the subtopic level of FASB ASC 815 (for example, FASB ASC 815-30-50 provides additional guidance regarding disclosures for cash flow hedges).

4.88 For derivative instruments that are not designated or do not qualify as hedging instruments under FASB ASC 815, paragraph 50–4F of FASB ASC 815-10-50 notes that if the entity's policy is to include those derivative instruments in its trading activities (for example, as part of its trading portfolio that includes both derivative and nonderivative or cash instruments), the entity can elect to not separately disclose gains and losses as required by FASB ASC 815-10-50-4C(e). This election is available provided that certain information is disclosed about its trading activities (including both derivative and nonderivative instruments).

Guarantees

4.89 Under FASB ASC 460-10-50-4, guarantors are required to disclose the following even if the likelihood of the guarantor's having to make any payments under the guarantee is remote:

a. The nature of the guarantee, including its approximate term, how the guarantee arose, the events and circumstances that would require the guarantor to perform under the guarantee, the current status of the payment/performance risk of the guarantee, and certain information for those using internal groupings

b. The following information about the maximum potential amount of future payments under the guarantee, as appropriate:

   i. The undiscounted maximum potential amount of future payments the guarantor would be required to make under the guarantee, not reduced by any recourse or collateralization provisions

   ii. If the terms of the guarantee provide for no limitation to the maximum potential future payments under the guarantee, that fact

   iii. If the guarantor is unable to develop an estimate of the maximum potential amount of future payments under its guarantee, the reasons why it cannot estimate the maximum potential amount

c. The current carrying amount of the liability, if any, for the guarantor's obligations under the guarantee

d. The nature of any recourse provisions that would enable the guarantor to recover from third parties any amounts paid under the guarantee

e. The nature of any assets held either as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee

f. If estimable, the approximate extent to which the proceeds from liquidation of assets held either as collateral or by third parties would be expected to cover the maximum potential amount of future payments under the guarantee

4.90 Freestanding written put options and certain contracts which function as market value guarantees on a financial asset that is owned by the guaranteed party, even when classified as derivatives under FASB ASC 815, are within the scope of the disclosure provisions of FASB ASC 460.

Subsequent Events

4.91 FASB Statement No. 165, *Subsequent Events*, as codified in FASB ASC 855, *Subsequent Events*, provides guidance on subsequent events, including the time period through which subsequent events should be evaluated and the required disclosures.

4.92 Accounting Standards Update (ASU) 2010-09, *Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*, amended the guidance in FASB ASC 855 to alleviate potential conflicts between FASB ASC 855-10 and the SEC's requirements. ASU 2010-09 clarified that an SEC filer is not required to disclose the date through which subsequent events have been evaluated. As revised, FASB ASC 855-10-50-1 states that if the entity is not an SEC filer, it should disclose the date through which subsequent events have been evaluated, and whether that date represents the date the financial statements were issued or the date the financial statements were available to be issued. Because a broker-dealer is an SEC filer, it does not have to disclose the date through which subsequent events have been evaluated.

Financial Statements and Schedules

4.93 The financial statements required to be filed under Rule 17a-5 are not required to be in comparative form, and the following financial statement exhibits are not prepared on that basis. However, if comparative financial statements are prepared, there is no need to present the supplementary information on a comparative basis.

4.94 The following financial statement and schedule exhibits include the required facing page and the oath or affirmation form on Form X-17A-5. These exhibits are illustrative only and have been prepared to show how various items might be presented, assuming they are material in the particular circumstances. The financial statements of individual companies may vary from these illustrations depending on facts or circumstances present at the time of issuance.

4.95 The illustrative financial statements and footnote disclosures included in this guide have been updated to reflect FASB ASC. However, in FASB's notice to constituents, it suggests the use of plain English to describe broad FASB ASC topic references. They suggest a reference similar to "as required by the Derivatives and Hedging Topic of the FASB *Accounting Standards Codification*." Entities might consider revising their financial statement references to reflect this plain English referencing, rather than the use of specific FASB ASC references. We have provided these detailed references in this guide as a learning tool to familiarize constituents with the basis for the disclosures.

Exhibit 4-1

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

ANNUAL AUDITED REPORT FORM X-17A-5 PART III	Information Required of Brokers and Dealers Pursuant to Section 17 of the Securities Exchange Act of 1934 and Rule 17a-5 Thereunder	SEC FILE 8-12345

REPORT FOR THE PERIOD BEGINNING **01/01/X1** (MM/DD/YY) AND ENDING **12/31/X1** (MM/DD/YY)

A. REGISTRANT IDENTIFICATION

NAME OF BROKER-DEALER: OFFICIAL USE ONLY

Standard Stockbrokerage Co., Inc. ______________

ADDRESS OF PRINCIPAL PLACE OF BUSINESS: (Do not use P.O. Box No.)

1 Main Street

(No. and Street)

New York	**New York**	**10004**
(City)	(State)	(Zip Code)

NAME AND TELEPHONE NUMBER OF PERSON TO CONTACT IN REGARD TO THIS REPORT

Joseph P. Brokestock **(212) 555-1212**

(Area Code - Telephone No.)

B. ACCOUNTANT IDENTIFICATION

INDEPENDENT PUBLIC ACCOUNTANT (Whose opinion is contained in this Report*)
(Name . . . if individual, state last, first, middle name)

Accounting Firm

2 Main Street	**New York**	**New York**	**10004**
(Address)	(City)	(State)	(Zip Code)

CHECK ONE:

x Certified Public Accountant
o Public Accountant
o Accountant not resident in United States or any of its possessions.

FOR OFFICIAL USE ONLY

* *Claims for exemption from the requirement that the annual report be covered by the opinion of an independent public accountant must be supported by a statement of facts and circumstances relied on at the bureau of the exemption. See Section 240.17a-5(e)(2).*

Exhibit 4-2

Oath or Affirmation

I, JOSEPH P. BROKESTOCK, swear (or affirm) that, to the best of my knowledge and belief, the accompanying financial statements and supporting schedules pertaining to the firm of STANDARD STOCKBROKERAGE CO., INC., as of DECEMBER 31, 20X1, are true and correct. I further swear (or affirm) that neither the Company nor any partner, proprietor, principal officer, or director has any proprietary interest in any account classified solely as that of a customer, except as follows:

SECURITY ACCOUNTS OF PRINCIPAL OFFICERS AND DIRECTORS THAT ARE CLASSIFIED AS CUSTOMER ACCOUNTS (DEBITS $316,513, CREDITS $273,412)

____
Signature
VICE PRESIDENT — FINANCE
Title

Subscribed and sworn
to before me
this____day of ____20X2

____
JOAN P. NOTARY
Notary Public

This report * contains (check all applicable boxes)

x (a) Facing page.

x (b) Statement of financial condition.

x (c) Statement of income (loss).

x (d) Statement of cash flows.

x (e) Statement of changes in stockholders' equity or partners' or sole proprietor's capital.

x (f) Statement of changes in liabilities subordinated to claims of general creditors.

x (g) Computation of net capital for brokers and dealers pursuant to Rule 15c3-1.

x (h) Computation for determination of reserve requirements pursuant to Rule 15c3-3.

x (i) Information relating to the possession or control requirements for brokers and dealers under Rule 15c3-3.

o (j) A reconciliation, including appropriate explanation, of the computation of net capital under Rule 15c3-1 and the computation for determination of the reserve requirements under exhibit A of Rule 15c3-3.

o (k) A reconciliation between the audited and unaudited statements of financial condition with respect to methods of consolidation.

x (l) An oath or affirmation.

x (m) A copy of the SIPC supplemental report.

o (n) A report describing any material inadequacies found to exist or found to have existed since the date of the previous audit.

x (o) Independent auditor's report on internal control.[9]

x (p) Schedule of segregation requirements and funds in segregation—customers' regulated commodity futures account pursuant to Rule 171-5.

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* *For conditions of confidential treatment of certain portions of this filing, see Section 240.17a–5(e)(3).*

Note: Various exchanges may require an additional letter of attestation.

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[9] See appendix C, "Report on Internal Control Required by SEC Rule 17a-5(g)(1)," in this guide.

Exhibit 4-3

Standard Stockbrokerage Co., Inc. and Subsidiaries
Consolidated Statement of Financial Condition
December 31, 20X1
(Dollars in Thousands, Except Share Data)

Assets

Cash	$2,647
Cash and securities segregated under federal and other regulations (cash of $375 and securities with a fair value of $630)	1,005
Collateralized Agreements:	
Securities borrowed	2,500
Securities purchased under agreements to resell, at fair-value	3,782
Securities received as collateral	200
Deposits with clearing organizations and others (cash of $345 and securities with a fair value of $1,400)	1,745
Receivable from broker-dealers and clearing organizations	25,476
Receivable from customers†	40,360
Securities owned, at fair value ($28,468 pledged as collateral)*	31,468
Spot commodities owned, at fair value*	3,278
Secured demand notes	5,215
Memberships in exchanges owned, at adjusted cost (fair value $2,500)	2,475
Furniture, equipment, and leasehold improvements, at cost, less accumulated depreciation and amortization of $2,425	4,881
Other assets	523
	$125,555

Liabilities and Stockholders' Equity

Liabilities:	
Short-term bank loans	$26,900
Drafts payable	2,210
Collateralized Agreements:	
Securities loaned	1,800
Securities sold under agreements to repurchase, at fair value	3,790
Payable to broker-dealers and clearing organizations	19,164
Payable to customers	12,288
Securities sold, not yet purchased, at fair value	1,862
Obligation to return securities received as collateral	200
Income taxes payable, including deferred taxes of $1,200	2,276
Accounts payable, accrued expenses, and other liabilities	2,449
Long-term notes payable	3,000
	75,939
Commitments, contingencies and guarantees:	
Subordinated borrowings	9,897
Stockholders' equity:	
Preferred stock, $5 cumulative, $100 par value, authorized 100,000 shares, outstanding 50,000 shares	5,000
Common stock, $1 par value, authorized 10,000,000 shares, issued 6,000,000 shares	6,000
Additional paid-in capital	2,200
Retained earnings	27,719
	40,919
Less 199,100 shares of common stock in treasury, at cost	(1,200)
Total stockholders' equity	39,719
	$125,555

The accompanying notes are an integral part of these consolidated financial statements.

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* To the extent that collateral has been pledged and the counterparty has the right by contract or custom to sell or repledge the collateral, separate captions or parenthetical disclosures in the statement of financial condition may be needed as illustrated in FASB ASC 860-30.

† Valuation allowances should be shown, if material, either parenthetically or in a note.

Exhibit 4-4

Standard Stockbrokerage Co., Inc. and Subsidiaries

Consolidated Statement of Income

for the Year Ended December 31, 20X1

(***Dollars in Thousands, Except Earnings Per Share)***

Revenues	
Commissions	$26,549
Principal transactions	6,707
Investment banking	5,689
Interest and dividends	4,253
Investment advisory fees	2,420
Other income	400
	46,018
Expenses:	
Employee compensation and benefits	12,815
Floor brokerage, exchange, and clearance fees	7,128
Communications and data processing	5,723
Interest and dividends	3,896
Occupancy	1,625
Other expenses	1,127
	32,314
Income before income taxes	13,704
Provision for income taxes	7,100
Net income	$6,604
Basic and diluted earnings per share	$1.10

The accompanying notes are an integral part of these consolidated financial statements.

Exhibit 4-5

Standard Stockbrokerage Co., Inc. and Subsidiaries

Consolidated Statement of Changes in Subordinated Borrowings for the Year Ended December 31, 20X1

(Dollars in Thousands)

Subordinated borrowings at January 1, 20X1	$4,204
Increases:	
Secured demand note collateral agreements	3,325
Issuance of subordinated notes	3,675
Decreases:	
Payment of subordinated notes	(1,307)
Subordinated borrowings at December 31, 20X1	$9,897

The accompanying notes are an integral part of these consolidated financial statements.

Exhibit 4-6

Standard Stockbrokerage Co., Inc. and Subsidiaries
Consolidated Statement of Changes in Stockholders' Equity
for the Year Ended December 31, 20X1

(*Dollars in Thousands, Except Share Data*)

	Capital Stock				*Additional Paid-in Capital*	*Retained Earnings*	*Treasury Stock—Common*		*Total Stockholders' Equity*
	Preferred		*Common*						
	Shares	*Amount*	*Shares*	*Amount*	*Amount*	*Amount*	*Shares*	*Amount*	*Amount*
Balances at January 1, 20X1	52,500	$5,250	6,000,000	$6,000	$2,212	$21,365	195,700	$(1,098)	$33,729
Net Income						6,604			6,604
Purchase and retirement of preferred shares	(2,500)	(250)			(12)				(262)
Dividends on preferred stock $5 a share						(250)			(250)
Net purchase of common shares for treasury							3,400	(102)	(102)
Balance at December 31, 20X1	50,000	$5,000	6,000,000	$6,000	$2,200	$27,719	199,100	$(1,200)	$39,719

The accompanying notes are an integral part of these consolidated financial statements.

Exhibit 4-7

Standard Stockbrokerage Co., Inc. and Subsidiaries

Consolidated Statement of Cash Flows for the Year Ended December 31, 20X1

(Dollars in Thousands)

Cash flows from operating activities:		
Net income		$6,604
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	$582	
Deferred taxes	376	
(Increase) decrease in operating assets:		
Cash and securities segregated under federal and other regulations	500	
Deposits with clearing organizations and others	900	
Net receivable from broker-dealers and clearing organizations	4,785	
Net receivable from customers,	(11,830)	
Securities borrowed, net of securities loaned	(50)	
Securities purchased under agreements to resell*	2,648	
Securities owned, net	4,605	
Securities received as collateral	50	
Spot commodities owned	(2,914)	
Increase (decrease) in operating liabilities:		
Securities sold under agreements to repurchase*	587	
Obligation to return securities received as collateral	50	
Other, net	(691)	
Total adjustments		(402)
Net cash provided by operating activities		6,202
Cash flows from investing activities:		
Proceeds from sale of long-term investments	110	
Purchase of long-term investments	(50)	
Purchase of furniture, equipment, and leasehold improvements	(75)	
Net cash used in investing activities		(15)

(continued)

Cash flows from financing activities:		
Payment of short-term bank loans	(7,762)	
Proceeds from issuance of derivatives with a financing element, net†	100	
Proceeds from issuance of common stock from treasury	78	
Purchase of common stock for treasury	(180)	
Proceeds from issuance of subordinated notes	3,675	
Payments of subordinated notes	(1,307)	
Payments of long-term notes payable	(500)	
Purchase and retirement of preferred stock	(262)	
Dividend on preferred stock	(250)	
Net cash used in financing activities		(6,408)
Decrease in cash		(221)
Cash at beginning of the year		2,868
Cash at end of the year		$2,647
Supplemental cash flows disclosures:		
Income tax payments (paid to parent)		$6,700
Interest payments		$3,618
Noncash financing activity— borrowings under secured demand note collateral agreements		$3,325

The accompanying notes are an integral part of these consolidated financial statements.

* Depending on the nature of the activity, securities purchased under agreements to resell can be classified as operating or investing; likewise, securities sold under agreements to repurchase can be classified as operating or financing.

† Paragraphs 11–15 of FASB 815-10-45 require all cash flows associated with a derivative that contains an other-than-insignificant financing element at inception, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments (that is, the forward points in an at-the-money forward contract), to be reported as cash flows from financing activities in the statement of cash flows as opposed to reporting only the cash flows related to a financing element of a derivative as a financing activity.

Exhibit 4-8

Standard Stockbrokerage Co., Inc. and Subsidiaries

Notes to Consolidated Financial Statements[10]

December 31, 20X1

(*Dollars in Thousands)*

The following notes to financial statements are illustrative only. In some situations, the information in the notes may be better presented within the financial statements; in other situations, information not required by regulation may not be sufficiently material to warrant disclosure. In addition, these notes may not include all disclosures required by Regulation S-X.[11]

1. Organization and Nature of Business

Standard Stockbrokerage Co., Inc., (the Company) is a broker-dealer registered with the SEC and is a member of various exchanges and the Financial Industry Regulatory Authority (FINRA). The Company is a Delaware Corporation that is a majority-owned subsidiary of Standard Stockbrokerage Holding Company, Inc. (Parent).

2. Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. The Company is engaged in a single line of business as a securities broker-dealer, which comprises several classes of services, including principal transactions, agency transactions, investment banking, investment advisory, and venture capital businesses. All material intercompany balances and transactions are eliminated in consolidation.

Basis of Presentation

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Securities Owned

Proprietary securities transactions in regular-way trades are recorded on the trade date, as if they had settled. Profit and loss arising from all securities and commodities transactions entered into for the account and risk of the Company are recorded on a trade date basis. Customers' securities and commodities transactions are reported on a settlement date basis with related commission income and expenses reported on a trade date basis.[12]

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[10] These notes do not reflect all disclosures required under U.S. GAAP. The notes will continue to be updated in future editions of this guide to the extent applicable.

[11] A discussion of the disclosures related to significant risks and uncertainties is included in paragraphs 4.75–.84 in this guide.

[12] See chapter 7 of this guide regarding settlement-date-basis versus trade-date-basis accounting.

Amounts receivable and payable for securities transactions that have not reached their contractual settlement date are recorded net on the consolidated statement of financial condition.

Securities are recorded at fair value in accordance with FASB ASC 820, *Fair Value Measurements and Disclosures*.

Collateralized Agreements

Transactions involving securities purchased under agreements to resell (reverse repurchase agreements or reverse repos) or securities sold under agreements to repurchase (repurchase agreements or repos) are accounted for as collateralized agreements or financings except where the Company does not have an agreement to sell (or purchase) the same or substantially the same securities before maturity at a fixed or determinable price. It is the policy of the Company and subsidiaries to obtain possession of collateral with a fair value equal to or in excess of the principal amount loaned under resale agreements. Collateral is valued daily, and the Company may require counterparties to deposit additional collateral or return collateral pledged when appropriate. Reverse repos and repos are carried at fair value, beginning January 1, 20X0 for contracts acquired after that date. Interest on such contract amounts is accrued and is included in the consolidated statement of financial condition in receivables from and payables to broker-dealers and clearing organizations.[13]

Securities borrowed and securities loaned transactions are generally reported as collateralized financings except where letters of credit or other securities are used as collateral. Securities borrowed transactions require the Company to deposit cash, letters of credit, or other collateral with the lender. With respect to securities loaned, the Company receives collateral in the form of cash or other collateral in an amount generally in excess of the fair value of securities loaned. The Company monitors the fair value of securities borrowed and loaned on a daily basis, with additional collateral obtained or refunded as necessary. Securities borrowed and securities loaned transactions are recorded at the amount of cash collateral advanced or received adjusted for additional collateral obtained or received. Interest on such transactions is accrued and is included in the consolidated statement of financial condition in receivables from and payables to broker-dealers and clearing organizations.

The Company nets certain repurchase agreements and resale agreements with the same counterparty in the consolidated statement of financial condition when the requirements of FASB ASC 210-20-45-11 are met.

Offsetting of Amounts Related to Certain Contracts

When the requirements of FASB ASC 815-10-45-5 are met, the Company offsets certain fair value amounts recognized for cash collateral receivables or payables against fair value amounts recognized for net derivative positions executed with the same counterparty under the same master netting arrangement.

Investment Banking

Investment banking revenues include gains, losses, and fees, net of syndicate expenses, arising from securities offerings in which the Company acts as an underwriter or agent. Investment banking revenues also include fees earned from

[13] Alternatively, accrued interest can be reported on either its own line (such as "accrued interest receivable") or as part of the "repurchase agreements" or "reverse repurchase agreements" lines.

providing merger-and-acquisition and financial restructuring advisory services. Investment banking management fees are recorded on offering date, sales concessions on settlement date, and underwriting fees at the time the underwriting is completed and the income is reasonably determinable.

Commissions

Commissions and related clearing expenses are recorded on a trade-date basis as securities transactions occur.

Investment Advisory Income

Investment advisory fees are received quarterly but are recognized as earned on a pro rata basis over the term of the contract.

Translation of Foreign Currencies

Assets and liabilities denominated in foreign currencies are translated at year-end rates of exchange, whereas the income statement accounts are translated at average rates of exchange for the year. Gains or losses resulting from foreign currency transactions are included in net income.

Income Taxes

The Company and its subsidiaries are included in the consolidated federal income tax return filed by the Parent. Federal income taxes are calculated as if the companies filed on a separate return basis, and the amount of current tax or benefit calculated is either remitted to or received from the Parent. The amount of current and deferred taxes payable or refundable is recognized as of the date of the financial statements, utilizing currently enacted tax laws and rates. Deferred tax expenses or benefits are recognized in the financial statements for the changes in deferred tax liabilities or assets between years.

The Company recognizes and measures its unrecognized tax benefits in accordance with FASB ASC 740, *Income Taxes*. Under that guidance the Company assesses the likelihood, based on their technical merit, that tax positions will be sustained upon examination based on the facts, circumstances and information available at the end of each period. The measurement of unrecognized tax benefits is adjusted when new information is available, or when an event occurs that requires a change.

Depreciation

Depreciation is provided on a straight-line basis using estimated useful lives of five to ten years. Leasehold improvements are amortized over the lesser of the economic useful life of the improvement or the term of the lease.

Drafts Payable

Drafts payable represent amounts drawn by the Company against a bank and sight overdrafts under a sweep agreement with a bank.

Exchange Memberships

The Company's exchange memberships, which represent ownership interests in the exchanges and provide the Company with the right to conduct business on the exchanges, are recorded at cost or, if an other than temporary impairment in value has occurred, at a value that reflects management's estimate of the impairment. Management believes that such impairment in value occurred in

20W7, at which time the Company wrote down the cost of its exchange memberships. There were no exchange membership impairments in 20X1. At December 31, 20X1, the fair value of exchange memberships was $2,500.

Statement of Cash Flows

For purposes of the Consolidated Statement of Cash Flows, the Company has defined cash equivalents as highly liquid investments, with original maturities of less than three months, that are not held for sale in the ordinary course of business.

3. Fair Value[14]

Fair Value Measurement

FASB ASC 820 defines fair value, establishes a framework for measuring fair value, and establishes a fair value hierarchy which prioritizes the inputs to valuation techniques. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market. Valuation techniques that are consistent with the market, income or cost approach, as specified by FASB ASC 820, are used to measure fair value.

The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities the Company has the ability to access.
- 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 are unobservable inputs for the asset or liability and rely on management's own assumptions about the assumptions that market participants would use in pricing the asset or liability. (The unobservable inputs should be developed based on the best information available in the circumstances and may include the Company's own data.)

The following table presents the Company's fair value hierarchy for those assets and liabilities measured at fair value on a recurring basis as of December 31, 20X1.

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[14] In addition to the information presented here, FASB ASC 820-10-50-2e states that for fair value measurements using significant other observable inputs (level 2) and significant unobservable inputs (level 3), a description of the valuation technique(s) used and the inputs used in determining fair value should be disclosed. If there has been a change in valuation technique(s) used to measure fair value, that change and the reason for making the change should be disclosed. Also, FASB ASC 820-10-50-5 provides guidance on the disclosures that are required for assets and liabilities measured at fair value on a nonrecurring basis for periods subsequent to initial recognition. FASB ASC 820-10-50-9 states that the reporting entity is encouraged, but not required, to combine the fair value information disclosed under FASB ASC 820 with the fair value information disclosed under other subtopics. This note is for illustrative purposes only and is not intended to include all disclosures required under the topic. See FASB ASC 820-10-50 for more information.

Fair Value Measurements on a Recurring Basis
As of December 31, 20X1
(Dollars in Thousands)

	Level 1	*Level 2*	*Level 3*	*Netting and Collateral*	*Total*
ASSETS					
Cash and securities segregated under federal and other regulations	$630	$—	$—	$—	$630
Securities purchased under agreements to resell	—	3,782	—	—	3,782
Securities owned:					
U.S. government and agency	5,321	4,859	—	—	10,180
Corporate and other debt	574	3,468	4,198	—	8,240
Residential mortgage and other asset backed securities	—	4,271	1,897	—	6,168
Equities	5,955	—	—	—	5,955
Derivatives	50	709	466	(300)	925
Spot commodities owned	—	3,278	—	—	3,278
TOTALS	$12,530	$20,367	$6,561	$(300)	$39,158
LIABILITIES					
Securities sold under agreements to repurchase	$—	$3,790	$—	$—	$3,790
Securities sold, not yet purchased:					
U.S. government and agency	430	150	—	—	580
Corporate and other debt	—	10	—	—	10
Equities	622	—	—	—	622
Derivatives	—	500	200	(50)	650
TOTALS	$1,052	$4,450	$200	$(50)	$5,652

The following is a reconciliation of the beginning and ending balances for assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (level 3) during the year ended December 31, 20X1:

Level 3 Financial Assets and Liabilities
Year ended December 31, 20X1
(*Dollars in Thousands*)

		Total Gains/Losses Included in Income					
		Principal Transactions					
	Beginning Balance	*Unrealized Gains and (Losses) Related to Assets Held at Year End*	*Realized Gains and (Losses) Related to Assets No Longer Held*	*Investment Banking Realized Gains and (Losses) No Positions Held at Year End*	*Purchases, Issuances, and Settlements*	*Transfers In (Out)*	*Ending Balance*
ASSETS							
Corporate and other debt	$3,758	$28	$182	$(75)	$(80)	$485	$4,298
Residential mortgages and other asset-backed securities	1,828	(33)	88	70	(81)	65	1,937
Derivatives	175	45	(10)	(70)	186	—	326
Total	$5,761	$40	$260	$(75)	$25	$550	$6,561
LIABILITIES							
Derivatives	$75	$60	$(5)	$(40)	$110	—	$200

Fair Value Option[15]

FASB ASC 825, *Financial Instruments*, provides a fair value option election that allows entities to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and liabilities. Changes in fair value are recognized in earnings as they occur for those assets and liabilities for which the election is made. The election is made on an instrument by instrument basis at initial recognition of an asset or liability or upon an event that gives rise to a new basis of accounting for that instrument. The fair value option has been elected for certain financial instruments that are not accounted for at fair value under other applicable accounting guidance.

At January 1, 20X1, the Company elected the fair value option on a prospective basis for securities purchased under agreements to resell and securities sold under agreements to repurchase.

The following table presents a summary of financial assets and liabilities for which the fair value option has been elected:

	Changes in Fair Value for the Year Ended December 31, 20X1 for Items Measured at Fair Value Pursuant to the Fair Value Option		
	Gains/Losses Principal Transactions	*Gains Other Income*	*Total Changes in Fair Value*
ASSETS			
Securities purchased under agreement to resell	$60	$5	$65
LIABILITIES			
Securities sold under agreement to repurchase	$(42)	$(17)	$(59)

4. Cash and Securities Segregated Under Federal and Other Regulations

Cash of $275 and U.S. Treasury bills with a fair value of $630 are segregated under the Commodity Exchange Act and represent funds deposited by customers and funds accruing to customers as a result of trades or contracts.

Cash of $100 has been segregated in a special reserve bank account for the benefit of customers under Rule 15c3-3 of the SEC or agreements for proprietary accounts of introducing brokers (PAIB).[16]

[15] FASB ASC 825, *Financial Instruments*, states that in annual periods only, an entity should disclose the methods and significant assumptions used to estimate the fair value of items for which the fair value option has been elected. In addition, as of each date for which a statement of financial position is presented, an entity should disclose certain other information that relates the information in the note to the financial statements numbers and disclosure should be made of certain information regarding any partial elections within a group of similar eligible items. Also, FASB ASC 825 requires disclosures that relate to particular types of assets or liabilities for which the fair value option may be elected. This note is for illustrative purposes only and is not intended include all disclosures required under the topic. See FASB ASC 825-10-50 for more information on the disclosures required.

[16] This is possible wording for those situations in which a deposit is required based on SEC Rule 15c3-3 or PAIB computations or both.

5. Receivable From and Payable to Broker-Dealers and Clearing Organizations

Amounts receivable from and payable to broker-dealers and clearing organizations at December 31, 20X1, consist of the following:

	Receivable	*Payable*
Deposits for securities borrowed/loaned	$7,756	$7,395
Securities failed-to-deliver/receive	13,646	1,014
Payable to clearing broker	—	9,350
Receivable from clearing organizations	2,173	—
Fees and commissions receivable/payable	1,312	1,196
Other	589	209
	$25,476	$19,164

The Company clears certain of its proprietary and customer transactions through another broker-dealer on a fully disclosed basis. The amount payable to the clearing broker relates to the aforementioned transactions and is collateralized by securities owned by the Company.

6. Receivable From and Payable to Customers

Accounts receivable from and payable to customers include amounts due on cash and margin transactions. Securities owned by customers are held as collateral for receivables.

7. Bank Loans

Customer loans of $18,400 are collateralized by $24,000 of customers' margin account securities, and firm loans of $8,500 are collateralized by $14,800 of securities owned by the Company and $3,000 of securities held pursuant to secured demand note collateral agreements.

8. Long-Term Notes Payable

The long-term notes payable of $3,000 bear interest at 6.5 percent and are payable in semiannual installments of $250 through July 1, 20X6. Furniture and equipment with a net carrying value of $2,500 has been pledged as sole recourse to secure the notes. The fair value of the long-term notes payable is $3,300.

9. Related Party

The Company is involved in significant financing and other transactions, and has significant related party balances with affiliates.

The following table sets forth the Company's related party assets and liabilities as of December 31, 20X1:

	December 31, 20X1
ASSETS	
Securities borrowed	$700
Securities purchased under agreements to resell, at fair value	880
Receivable from broker-dealers and clearing organizations	4,280
Receivable from customers	7,240
Securities owned, at fair value	529
Loans receivable from parent and affiliates (included in other assets)	125
Total assets	$13,754
LIABILITIES	
Securities loaned	$1,101
Securities sold under agreements to repurchase, at fair value	1,535
Payable to broker-dealers and clearing organizations	8,490
Payable to customers	2,424
Income taxes payable	2,276
Accounts payable, accrued expenses, and other liabilities	1,526
Subordinated borrowings	9,897
Total liabilities	$27,249

Included in the consolidated statement of income are revenues and expenses resulting from various securities trading and financing activities with certain affiliates, as well as fees for administrative services performed by the Company under the terms of various agreements.

The following table sets forth the Company's related party revenues and expenses for the year ended December 31, 20X1:

	20X1
Commissions	$724
Principal transactions	529
Investment banking	1,026
Interest	125
Other income	919
Total net revenues	$3,323
Floor brokerage, clearance, and other operating expenses	$4,280
Total expenses	$4,280

10. Subordinated Borrowings[17]

The borrowings under subordination agreements at December 31, 20X1, are listed in the following:

Subordinated notes, 10 percent, due December 31, 20X2	$4,307
Secured demand note collateral agreements, 6 percent, due $1,000 in March 20X2, $1,200 in March 20X3, and $3,015 in December 20X3	5,215
Exchange memberships contributed for the use of the Company	375
	$9,897

The subordinated borrowings are with related parties and are available in computing net capital under the SEC's uniform net capital rule. To the extent that such borrowings are required for the Company's continued compliance with minimum net capital requirements, they may not be repaid. It is the Company's intention not to renew the secured demand note collateralizing agreements due on March 20X2.[18]

The fair market value of subordinated borrowings is $10,800.

11. Preferred Stock

The preferred stock is redeemable at the option of the Company at $105 a share. There are no calls or puts on the preferred stock.

12. Financial Instruments[||]

Derivative financial instruments used for trading purposes, including economic hedges of trading instruments, are carried at fair value. Fair values for exchange-traded derivatives, principally futures and certain options, are based on quoted market prices. Fair values for over-the-counter derivative financial instruments, principally forwards, options, and swaps, are based on internal pricing models as no quoted market prices exist for such instruments. Factors taken into consideration in estimating the fair value of OTC derivatives include credit spreads, market liquidity, concentrations, and funding and administrative costs incurred over the life of the instruments.

Derivatives used for economic hedging purposes include swaps, forwards, futures, and purchased options. Unrealized gains or losses on these derivative contracts are recognized currently in the statement of income as principal transactions. The Company does not apply hedge accounting as defined in FASB ASC 815, *Derivatives and Hedging*, as all financial instruments are recorded at fair value with changes in fair values reflected in earnings. Therefore, certain of the disclosures required under FASB ASC 815 are generally not applicable with respect to these financial instruments.

Fair values of forwards, swaps, and options contracts are recorded in securities owned or securities sold, not yet purchased, as appropriate. Open equity in futures transactions is recorded as receivables from and payables to broker-dealers and clearing organizations, as applicable.

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[17] Significant restrictive covenants of debt agreements should be disclosed.

[18] Because of the unique characteristics of subordinated borrowings, additional disclosure of the amount for which six months' notice has been given of intent to withdraw is necessary.

[||] This note does not reflect all required elements for recently issued guidance related to financial instruments. This note will be updated in a subsequent edition of the guide.

Premiums and unrealized gains and losses for written and purchased option contracts, as well as unrealized gains and losses on interest rate swaps, are recognized gross in the consolidated statement of financial condition. The unrealized gains for delayed-delivery, to-be-announced (TBA), and when-issued securities generally are recorded in the consolidated statement of financial condition net of unrealized losses by counterparty where master netting agreements are in place.

Principal Transactions[#]

The Company's principal transaction by reporting categories, including derivatives, at December 31, 20X1, are the following:

Fixed income	$2,607
Equity	3,500
Foreign exchange and other derivative financial instruments	600
	$6,707

Fair Value of Financial Instruments[19]

The financial instruments of the Company are reported in the consolidated statement of financial condition at fair values, or at carrying amounts that approximate fair values because of the short maturity of the instruments, except long-term notes payable, and subordinated borrowings. The fair values of these financial instruments at December 31, 20X1, are as follows:[20]

	Assets (Liabilities)	
	Carrying Amount	*Fair Value*
Long-term notes payable	$(3,000)	$(3,300)
Subordinated borrowings	$(9,897)	$(10,800)

[#] FASB ASC 815-10-50-4F provides an alternative disclosure option for derivative instruments that are not designated or qualifying as hedging instruments under FASB ASC 815-20. If an entity's policy is to include those derivative instruments in its trading activities, the entity may elect to not separately disclose gains and losses as required by FASB ASC 815-10-50-4C(e) provided that the entity discloses all of the following:

1. The gains and losses on its trading activities (including both derivative and nonderivative instruments) recognized in the statement of financial condition, separately by major types of items (such as fixed income/interest rates, foreign exchange, equity, commodity, and credit).
2. The line items in the statement of financial performance in which trading activities gains and losses are included.
3. A description of the nature of its trading activities and related risks, and how the entity manages those risks.

If this alternative disclosure option is elected, the entity should include a footnote in the required tables referencing the use of alternative disclosures for trading activities.

[19] For annual reporting periods, FASB ASC 825-10-50-3 makes the disclosures about fair value of financial instruments optional for entities that meet all of the following criteria:

1. The entity is a nonpublic entity.
2. The entity's total assets are less than $100 million on the date of the financial statements.
3. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB ASC 815, other than commitments related to the origination of mortgageloans to be held for sale, during the reporting period.

[20] When carrying amounts and fair values are the same, the table may be omitted if that is stated.

The fair value of the Company's long-term notes payable and subordinated borrowings are based on current rates offered to the Company for debt with substantially the same characteristics and maturities.

Financial Instruments With Off-Balance-Sheet Risk

The Company enters into various transactions involving derivatives and other off-balance sheet financial instruments. These financial instruments include futures, forward and foreign exchange contracts, exchange-traded and over-the-counter options, delayed deliveries, mortgage-backed TBAs, securities purchased and sold on a when-issued basis (when-issued securities), and interest rate swaps. These derivative financial instruments are used to meet the needs of customers, conduct trading activities, and manage market risks and are, therefore, subject to varying degrees of market and credit risk. Derivative transactions are entered into for trading purposes or to economically hedge other positions or transactions.

Futures and forward contracts and TBAs and when-issued securities provide for the delayed delivery of the underlying instrument. As a writer of options, the Company receives a premium in exchange for giving the counterparty the right to buy or sell the security at a future date at a contracted price. Interest rate swaps involve the exchange of payments based on fixed or floating rates applied to notional amounts. The contractual or notional amounts related to these financial instruments reflect the volume and activity and do not reflect the amounts at risk. Futures contracts are executed on an exchange, and cash settlement is made on a daily basis for market movements. Accordingly, futures contracts generally do not have credit risk. The credit risk for forward contracts, TBAs, options, swaps, and when-issued securities is limited to the unrealized fair valuation gains recorded in the statement of financial condition. Market risk is substantially dependent upon the value of the underlying financial instruments and is affected by market forces such as volatility and changes in interest and foreign exchange rates.

The Company had certain other transactions which, in accordance with industry practice, were not recorded on the statement of financial condition. At December 31, 20X1, the Company had commitments to enter into future resale and repurchase agreements. At December 31, 20X1, the Company had also borrowed securities and pledged securities against those borrowed securities.

In addition, the Company has sold securities that it does not currently own and will therefore be obligated to purchase such securities at a future date. The Company has recorded these obligations in the financial statements at December 31, 20X1, at fair values of the related securities and will incur a loss if the fair value of the securities increases subsequent to December 31, 20X1.

In the normal course of business, the Company's customer activities involve the execution, settlement, and financing of various customer securities transactions. These activities may expose the Company to off-balance-sheet risk in the event the customer or other broker is unable to fulfill its contracted obligations and the Company has to purchase or sell the financial instrument underlying the contract at a loss.

The Company's customer securities activities are transacted on either a cash or margin basis. In margin transactions, the Company extends credit to its customers, subject to various regulatory and internal margin requirements, collateralized by cash and securities in the customers' accounts. In connection

with these activities, the Company executes and clears customer transactions involving the sale of securities not yet purchased, substantially all of which are transacted on a margin basis subject to individual exchange regulations. Such transactions may expose the Company to significant off-balance-sheet risk in the event margin requirements are not sufficient to fully cover losses that customers may incur. In the event the customer fails to satisfy its obligations, the Company may be required to purchase or sell financial instruments at prevailing market prices to fulfill the customer's obligations. The Company seeks to control the risks associated with its customer activities by requiring customers to maintain margin collateral in compliance with various regulatory and internal guidelines. The Company monitors required margin levels daily and, pursuant to such guidelines, requires the customer to deposit additional collateral or to reduce positions when necessary.

The Company's customer financing and securities settlement activities require the Company to pledge customer securities as collateral in support of various secured financing sources such as bank loans and securities loaned. In the event the counterparty is unable to meet its contractual obligation to return customer securities pledged as collateral, the Company may be exposed to the risk of acquiring the securities at prevailing market prices in order to satisfy its customer obligations. The Company controls this risk by monitoring the fair value of securities pledged on a daily basis and by requiring adjustments of collateral levels in the event of excess market exposure. In addition, the Company establishes credit limits for such activities and monitors compliance on a daily basis.

Quantitative Disclosures for Derivative Financial Instruments Used for Trading Purposes

As of December 31, 20X1, the gross contractual or notional amounts of derivative financial instruments are as follows:

	Notional or Contract Amount
Interest Rate:	
Swap agreements, including options, swaptions, caps, collars, and floors	$50
Futures contracts	5
Options held	2
Foreign Exchange:	
Futures contracts	5
Forward contracts	23
Options held	1
Options written	2
Mortgage-Backed Securities:	
Forward contracts	10
Equity:	
Swap agreements	22
Futures contracts	5
Options held	1
Options written	1
Total	$127

The majority of the Company's transactions with off-balance-sheet risk are short-term in duration with a weighted average maturity of approximately 1.65 years at December 31, 20X1. The remaining maturities for notional or contract amounts outstanding for derivative financial instruments are as follows:[21]

	Less Than 1 year	*1–3 Years*	*3–5 Years*	*Greater Than 5 Years*	*Total*
Swap agreements	$20	$25	$16	$11	$72
Futures contracts	9	5	1		15
Forward contracts	33				33
Options held	4				4
Options written	3	—	—	—	3
Total	$69	$30	$17	$11	$127
Percent of total	54%	24%	13%	9%	100%

The fair values of derivative financial instruments included in securities owned and securities sold, not yet purchased as of December 31, 20X1, and the average monthly fair value of the instruments for the year ended December 31, 20X1, are as follows:

	Fair Value at Year-End		*Average Fair Values*	
	Assets	*Liabilities*	*Assets*	*Liabilities*
Swap agreements	$688	$348	$499	$226
Future contracts	40		30	
Forward contracts	169	61	31	15
Options held	328		203	
Options written	—	291	—	123
Total derivatives	$1,225	$700	$763	$364
Cash collateral	(200)	(40)		
Netting	(100)	(10)		
Total carrying value	$925	$650		

The following table summarizes the credit quality of the Company's over-the-counter derivatives by showing internal counterparty credit ratings for the net exposure (net of collateral of $200) of contracts in an asset position at December 31, 20X1.[22]

[21] The disclosure of the remaining maturities for notional or contract amounts for derivative financial instruments is encouraged, but not required.

[22] Qualitative disclosure for derivative financial instruments such as this table is encouraged, but not required.

*Rating**	*Net Exposure*
AAA	$525
AA	220
A	130
BBB and lower	100
Other[†]	50
Total	$1,025

* Rating Agency Equivalent

† *Other* indicates counterparties for which no credit was available from an independent third-party source. It does not necessarily indicate the counterparties' credit is below investment grade.

Credit-Risk-Related Contingent Features in Derivatives

Certain of the Company's derivative instruments contain provisions that require the Company's debt to maintain an investment grade credit rating from each of the major credit rating agencies. If the Company's debt were to fall below investment grade, it would be in violation of these provisions, and the counterparties to the derivative instruments could request immediate payment or demand immediate and ongoing full overnight collateralization on derivative instruments in net liability positions. The aggregate fair value of all derivative instruments with credit-risk-related contingent features that are in a liability position on December 31, 20X1, is $100 for which the Company has posted collateral of $40 in the normal course of business. If the credit-risk-related contingent features underlying these agreements were triggered on December 31, 20X1, the Company would be required to post an additional $15 of collateral to its counterparties.

Derivative Financial Instruments Used for Purposes Other Than Trading

The Company enters into derivative contracts to economically hedge exposures or to modify the characteristics of financial instruments or transactions.

Open derivative contracts, which are linked to assets or liabilities that are sold or otherwise disposed of, are terminated at the time of disposition. Unrealized gains or losses on such derivative contracts are recognized in the statement of income currently as revenue from principal transactions.

At December 31, 20X1, the Company had outstanding interest rate and currency swap agreements with a notional principal amount of $800. The swaps are recorded at fair value, and changes in fair value are included in income currently.

Concentrations of Credit Risk

The Company and its subsidiaries are engaged in various trading and brokerage activities in which counterparties primarily include broker-dealers, banks, and other financial institutions. In the event counterparties do not fulfill their obligations, the Company may be exposed to risk. The risk of default depends on the creditworthiness of the counterparty or issuer of the instrument. It is the Company's policy to review, as necessary, the credit standing of each counterparty.

13. Commitments and Contingent Liabilities

The Company is contingently liable as of December 31, 20X1, in the amount of $4,375 under bank guarantees and has outstanding letter-of-credit agreements aggregating $3,000 used in lieu of margin deposits. The Company has determined that these commitments do not meet the definition of a derivative, as defined by FASB ASC 815. These agreements are generally made for periods of six months to one year and bear interest at rates from 0.5 percent to 1 percent.

The Company and its subsidiaries have obligations under operating leases with initial noncancelable terms in excess of one year. Aggregate annual rentals for office space and equipment at December 31, 20X1, are approximately as listed as follows:

20X2	$1,492
20X3	1,440
20X4	1,006
20X5	982
20X6	901
Later years	1,164
	$6,985

Certain leases contain renewal options and escalation clauses. Rent expense for 20X1 aggregated to $1,519 and is included in the *Occupancy* expense line item on the Consolidated Statement of Income.

The Company and a subsidiary—together with various other broker-dealers, corporations, and individuals—have been named as defendants in several class action lawsuits that allege violations of federal and state securities laws and claim substantial damages. The Company is also a defendant in other lawsuits incidental to its securities and commodities business. Management of the Company, after consultation with outside legal counsel, believes that the resolution of these various lawsuits will not result in any material adverse effect on the Company's consolidated financial position.

In the normal course of business, the Company enters into underwriting commitments. Transactions relating to such underwriting commitments that were open at December 31, 20X1, and were subsequently settled had no material effect on the financial statements as of that date.

14. Guarantees

FASB ASC 460, *Guarantees*, requires the Company to disclose information about its obligations under certain guarantee arrangements. FASB ASC 460 defines guarantees as contracts and indemnification agreements that contingently require a guarantor to make payments to the guaranteed party based on changes in an underlying (such as an interest or foreign exchange rate, security or commodity price, an index or the occurrence or nonoccurrence of a specified event) related to an asset, liability or equity security of a guaranteed party. This guidance also defines guarantees as contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an agreement as well as indirect guarantees of the indebtedness of others.

Derivative Contracts

Certain derivative contracts that the Company has entered into meet the accounting definition of a guarantee under FASB ASC 460. Derivatives that meet the FASB ASC 460 definition of guarantees include certain written options and credit default swaps. Because the Company does not track the counterparties' purpose for entering into a derivative contract, it has disclosed derivative contracts that are likely to be used to protect against a change in an underlying financial instrument, regardless of their actual use.

The maximum potential payout for certain derivative contracts, such as written interest rate caps and written foreign currency options, cannot be estimated as increases in interest or foreign exchange rates in the future could possibly be unlimited. Therefore, in order to provide information regarding the maximum potential amount of future payments that the Company could be required to make under certain derivative contracts, the notional amount of the contracts has been disclosed.

The Company records all derivative contracts at fair value. For this reason, the Company does not monitor its risk exposure to derivative contracts based on derivative notional amounts; rather the Company manages its risk exposure on a fair value basis. Aggregate market risk limits have been established, and market risk measures are routinely monitored against these limits. The Company also manages its exposure to these derivative contracts through a variety of risk mitigation strategies, including, but not limited to, entering into offsetting economic hedge positions. The Company believes that the notional amounts of the derivative contracts generally overstate its exposure.

Indemnifications

In the normal course of its business, the Company indemnifies and guarantees certain service providers, such as clearing and custody agents, trustees and administrators, against specified potential losses in connection with their acting as an agent of, or providing services to, the Company or its affiliates. The Company also indemnifies some clients against potential losses incurred in the event specified third-party service providers, including subcustodians and third-party brokers, improperly executed transactions. The maximum potential amount of future payments that the Company could be required to make under these indemnifications cannot be estimated. However, the Company believes that it is unlikely it will have to make material payments under these arrangements and has not recorded any contingent liability in the consolidated financial statements for these indemnifications.

The Company provides representations and warranties to counterparties in connection with a variety of commercial transactions and occasionally indemnifies them against potential losses caused by the breach of those representations and warranties. The Company may also provide standard indemnifications to some counterparties to protect them in the event additional taxes are owed or payments are withheld, due either to a change in or adverse application of certain tax laws. These indemnifications generally are standard contractual terms and are entered into in the normal course of business. The maximum potential amount of future payments that the Company could be required to make under these indemnifications cannot be estimated. However, the Company believes that it is unlikely it will have to make material payments under these

arrangements and has not recorded any contingent liability in the consolidated financial statements for these indemnifications.

Exchange Member Guarantees

The Company is a member of various exchanges that trade and clear securities or futures contracts or both. Associated with its membership, the Company may be required to pay a proportionate share of the financial obligations of another member who may default on its obligations to the exchange. Although the rules governing different exchange memberships vary, in general the Company's guarantee obligations would arise only if the exchange had previously exhausted its resources. In addition, any such guarantee obligation would be apportioned among the other nondefaulting members of the exchange. Any potential contingent liability under these membership agreements cannot be estimated. The Company has not recorded any contingent liability in the consolidated financial statements for these agreements and believes that any potential requirement to make payments under these agreements is remote.

Other Guarantees

The Company, in its capacity as an agency lender, occasionally indemnifies securities lending customers against losses incurred in the event that borrowers do not return securities and the collateral held is insufficient to cover the fair value of the securities borrowed. In addition, the Company provides letters of credit and other guarantees, on a limited basis, to enable clients to enhance their credit standing and complete transactions.

The following table sets forth the maximum payout/notional amounts associated with the Company's guarantees as of December 31, 20X1:

Maximum Potential Payout/Notional

Years to Maturity

Type of Guarantee	*Less than 1*	*1–3*	*3–5*	*Over 5*	*Total*	*Carrying Amount*	*Collateral/ Recourse*
	(dollars in thousands)						
Derivative contracts	$XX	$XX	$XX	$XX	$XX	$XX	$XX
Securities lending indemnifications	$XX	$XX	$XX	$XX	$XX	$XX	$XX
Letters of credit and other guarantees	$XX	$XX	$XX	$XX	$XX	$XX	$XX

15. Net Capital Requirements

The Company is subject to the SEC Uniform Net Capital Rule (SEC Rule 15c3-1), which requires the maintenance of minimum net capital and requires that the ratio of aggregate indebtedness to net capital, both as defined, shall not exceed 15 to 1 (and the rule of the "applicable" exchange also provides that equity capital may not be withdrawn or cash dividends paid if the resulting net capital ratio would exceed 10 to 1).[23] The Company is also subject to the net capital requirements of the CFTC Regulation 1.17 and requirements of

[23] Various regulatory agencies and exchanges may impose additional capital requirements, which may be necessary to disclose.

the National Futures Association, and is required to maintain "adjusted net capital", equivalent to the greater of $1,000,000 or 8 percent of customer and noncustomer risk maintenance margin requirements on all positions, as these terms are defined.[24] At December 31, 20X1, the Company had net capital of $33,584, which was $29,381 in excess of its required net capital of $4,203. The Company's net capital ratio was 1.7 to 1.[25]

16. Income Taxes[**]

The Company is included in the consolidated federal income tax return filed by its Parent. Federal income taxes are calculated as if the Company filed a separate federal income tax return. The Company and its subsidiaries file their own state and local tax returns. The current and deferred portions of the income tax expense (benefit) included in the statement of operations as determined in accordance with FASB ASC 740 are as follows:

	Current	*Deferred*	*Total*
Federal	$5,204	$(304)	$4,900
State and local	1,280	680	1,960
Foreign	240	—	240
	$6,724	$376	$7,100

A reconciliation of the difference between the expected income tax expense or benefit computed at the U.S. statutory income tax rate and the Company's income tax expense is shown in the following table:[26]

Expected income tax expense at U.S. statutory tax rate	$4,659
The effect of:	
Nondeductible expenses	1,309
Increase due to state and local taxes, net of U.S. federal income tax effects	1,293
Tax-exempt income, net of related nondeductible interest expense	(427)
Other, net	266
Income tax expense[27]	$7,100

The Company recognizes the accrual of any interest and penalties related to unrecognized tax benefits in income tax expense. No interest or penalties were

[24] Only applicable if the broker-dealer is a futures commission merchant subject to Regulation 1.17 of the Commodity Futures Trading Commission.

[25] See illustrative schedule I (exhibit 4-9).

[**] As noted in FASB ASC 740-10-50-8, a nonpublic entity should disclose the types of significant temporary differences and carryforwards. This information will be added to this note in a subsequent edition of the guide.

[26] Optional disclosure for firms not subject to SEC Regulation S-X. An explanation of a disproportionate tax provision, however, is required under U.S. GAAP.

[27] See FASB ASC 740-10-50 for additional disclosures required, if material.

recognized in 20X1. The following is a reconciliation of the beginning and ending amounts of unrecognized tax benefits:

Balance at January 1, 20X1	$XX
Additions based on tax positions related to the current year	XX
Additions for tax positions of prior years	XX
Reductions for tax positions of prior years	XX
Settlements	XX
Expiration of Statute of Limitations	XX
Balance at December 31, 20X1	$XX

Of the balance at December 31, 20X1, approximately $XX represents the amount of unrecognized tax benefits that, if recognized, would favorably affect the effective tax rate in future years. The Company does not have any tax positions at the end of the year for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date.

The Parent and the Company are no longer subject to federal, state, or local tax examinations by taxing authorities for years before 20W4. The IRS commenced an examination of the Parent's federal income tax returns for the years 20W6 and 20W7 in the last quarter of 20W9 that is anticipated to be completed by the end of 20X2. As of December 31, 20X1, the IRS has not proposed any adjustment to the Company's tax position.

17. Basic Earnings Per Share

Basic earnings per share of common stock were computed by dividing income available to common stockholders (net income, less the preferred stock dividend requirement), by the weighted average number of common shares outstanding for the year. Diluted earnings per share are not presented because the Company has issued no dilutive potential common shares.

18. Consolidated Subsidiaries[28, 29]

The following is a summary of certain financial information of the Company's consolidated subsidiaries:

	Broker-Dealer Jr.	*Investment Advisory*	*Venture Capital*	*Total*
Total assets	$12,700	$1,700	$5,100	$19,500
Stockholders' equity	2,800	400	1,800	5,000

[28] Information in this note is presented to comply with FOCUS requirements (total assets and stockholders' equity of consolidated subsidiaries and treatment of the flow-through capital of the broker-dealer subsidiary). Readers should also consider FASB ASC 280, *Segment Reporting*, which requires that public business enterprises report financial and descriptive information about its reportable operating segments.

[29] See FASB ASC 810-10-50 for information on required disclosures related to consolidation. Note that FASB ASC 810-10-15-10 states that a majority-owned subsidiary that is not within the scope of the VIE subsections, and in which a parent has a controlling financial interest shall not be consolidated if the parent is a broker-dealer within the scope of Topic 940 and the control is likely to be temporary.

The $2,800 of stockholder's equity and $1,500 of the subordinated liabilities of the broker-dealer subsidiary are included as capital in a consolidated computation of the Company's net capital, because the assets of the subsidiary are readily available for the protection of the Company's customers, broker-dealers, and other creditors, as permitted by Rule 15c3-1, which resulted in an increase in net capital and required net capital (after nonallowable assets and charges) of $1,838 and $500, respectively. The accounts of the other subsidiaries are not included in the computation.

19. Collateral

The Company pledges its financial instruments owned to collateralize repurchase agreements and other securities financings. Pledged securities that can be sold or repledged by the secured party are identified in the consolidated statement of financial condition. The carrying value and classification of securities owned by the Company that have been loaned or pledged to counterparties where those counterparties do not have the right to sell or repledge the collateral were as follows:

	At December 31, 20X1
Financial instruments owned:	
U.S. government and agency securities	$1,000
Corporate and other debt	500
Residential mortgages and other asset backed securities	600
Corporate equities	900
Total	$3,000

Under the Company's collateralized financing agreements, the Company either receives or provides collateral. In many cases, the Company is permitted to sell or repledge these securities held as collateral. At December 31, 20X1, the fair value of securities received as collateral where the Company is permitted to sell or repledge the securities was $XX and the fair value of the portion that had been sold or repledged was $XX.

The Company additionally receives securities as collateral in connection with certain securities for securities transactions in which the Company is the lender. In instances where the Company is permitted to sell or repledge these securities, the Company reports the fair value of the collateral received and the related obligation to return the collateral in the consolidated statement of financial condition. At December 31, 20X1, $200, was reported as *Securities received as collateral* and an *Obligation to return securities received as collateral* in the consolidated statement of financial condition. Collateral received in connection with these transactions that was subsequently repledged was approximately $XX at December 31, 20X1.[30,31]

[30] Paragraphs 1–4 of FASB ASC 860 require disclosure of information about the sources and uses of that collateral.

[31] See footnote 28.

Exhibit 4-9

Supplementary Information
Pursuant to Rule 17a-5 of the
Securities Exchange Act of 1934

As of December 31, 20X1

The accompanying schedules are prepared in accordance with the requirements and general format of FOCUS Form X-17A-5. If desired, the preprinted FOCUS forms may be used for presenting the required supplementary information. The auditor should be aware of certain exemptive provisions under SEC Rule 15c3-3 regarding the determination of net capital requirements in the computation of net capital (Schedule I) and the computation for the determination of reserve requirements (Schedule II). If the exemptive provisions apply, a note should be added by the broker-dealer to the schedules, stating the basis under which the broker-dealer claims exemption.

Schedule I

Standard Stockbrokerage Co., Inc.

Computation of Net Capital Under Rule 15c3-1 of the Securities and Exchange Commission*

(*Dollars in Thousands)*

As of December 31, 20X1

Net Capital		
Total consolidated stockholders' equity		$39,719
Deduct stockholders' equity not allowable for net capital†		2,200
Total stockholders' equity qualified for net capital		37,519
Add:		
Subordinated borrowings allowable in computation of net capital		9,897
Other (deductions) or allowable credits-deferred income taxes payable		1,200
Total capital and allowable subordinated borrowings		48,616
Deductions/charges:		
Nonallowable assets:		
Securities not readily marketable	$1,730	
Exchange memberships	2,475	
Furniture, equipment, and leasehold improvements, net‡	2,381	
Other assets‖	98	
	6,684	
Additional charges for customers' and noncustomers' security accounts	825	
Additional charges for customers' and noncustomers' commodity accounts	78	
Aged fails-to-deliver	42	
Aged short security differences	44	
Secured demand note deficiency	525	
Commodity futures contracts and spot commodities/proprietary capital charges	163	
Other deductions/charges	514	8,875
Net capital before haircuts on securities positions (tentative net capital)		39,741
Haircuts on securities		
Contractual securities commitments	2,520	
Trading and investment securities		
Bankers' acceptances, certificates of deposit, and commercial paper	34	

(continued)

U.S. government agency and Canadian government obligations	1,155	
State and municipal government obligations	14	
Corporate obligations	1,242	
Stocks and warrants	893	
Options	212	
Undue concentrations	87	6,157
Net capital		$33,584
Aggregate indebtedness		
Items included in consolidated statement of financial condition:#		
Short-term bank loans (secured by customer's securities)		$18,400
Drafts payable		2,210
Payable to brokers and dealers		8,110
Payable to clearing broker		9,350
Payable to customers		11,716
Other accounts payable and accrued expenses		3,150
Items not included in consolidated statement of financial condition:		
Market value of securities borrowed for which no equivalent value is paid or credited		2,532
Other unrecorded amounts		1,158
Total aggregate indebtedness		$56,626
Computation of basic net capital requirement		
Minimum net capital required:		
Company		$ 3,775
Broker-dealer subsidiary		428
Total		$4,203
Excess net capital at 1,500 percent		$29,381
Excess net capital at 1,000 percent		$27,493
Ratio: Aggregate indebtedness to net capital		1.69 to 1
Reconciliation with Company's computation** (included in part II of Form X-17A-5 as of December 31, 20X1)		
Net capital, as reported in Company's part II (unaudited) FOCUS report		$35,154
Allowable assets erroneously reported as nonallowable:		
Deposits		582
Accrued interest receivable		378
Difference due to offsetting various asset accounts against related liabilities		(2,518)

Audit adjustments to record additional compensation	(600)
Other audit adjustments (net)	373
Other items (net)	215
Net capital per the preceding	$33,584
Computation of alternative net capital requirement[††]	
2 percent of aggregate debit items (or $250,000, if greater) as shown in formula for reserve requirements pursuant to Rule 15c3-3 prepared as of date of net capital computation—Company	$1,077
Capital requirement of consolidated broker-dealer subsidiary electing alternative method	250
Total net capital requirement	$1,327
Excess net capital[‡‡]	$32,257
Net capital in excess of	
4 percent of aggregate debit items	$31,106
5 percent of aggregate debit items	$30,236

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[*] Practitioners should consider the impact of recently issued accounting and regulatory pronouncements when preparing or auditing this supplementary schedule.

[†] Excludes stockholder's equity of investment advisory and venture capital subsidiaries. See note 18.

[‡] Excludes $2.5 million because of sole recourse of the related indebtedness.

[||] Excludes $222 of good-faith deposits for underwritings.

[#] Excludes balances of consolidated subsidiaries other than wholly-owned broker-dealer subsidiaries included in consolidated computation of net capital.

[**] If there is no material difference from the Company's computation and a reconciliation is not included, a statement to that effect is required. The following statement can be used to satisfy this requirement:

Note: There are no material differences between the preceding computation and the Company's corresponding unaudited part II of Form X-17A-5 as of December 31, 20X1.

This note can be placed at the end of this schedule or on every page of the schedule.

[††] To be included if the Company has elected to use the alternative method of computing net capital pursuant to appendix C of Rule 15c3-1. In this case, aggregate indebtedness and the computation of basic net capital may be excluded.

[‡‡] Net capital under the alternative method is computed on a basis similar to the basic net capital computation; the broker-dealer would incur a 1 percent charge on fails-to-deliver (offset by fails-to-receive).

Schedule II

Standard Stockbrokerage Co., Inc.

Computation for Determination of Reserve Requirements Under Rule 15c3-3 of the Securities and Exchange Commission*

(Standard Stockbrokerage Co., Inc. only)

(*Dollars in Thousands)*

As of December 31, 20X1

Credit balances	
Free credit balances and other credit balances in customers' security accounts (including nonregulated commodity accounts, net of related margin deposits of $322,300)	$10,716
Monies borrowed, collateralized by securities carried for the accounts of customers	18,400
Monies payable against customers' securities loaned	1,825
Customers' securities failed to receive (including credit balances in continuous net settlement accounts)	6,276
Credit balances in firm accounts that are attributable to principal sales to customers	1,238
Market value of stock dividends, stock splits, and similar distributions receivable outstanding over 30 calendar days	327
Market value of short security count differences over 30 calendar days old†	5
Market value of short securities and credits (not to be offset by "longs" or by debits) in all suspense accounts over 30 calendar days†	78
Market value of securities that are in transfer in excess of forty calendar days and have not been confirmed to be in transfer by the transfer agent or the issuer	38
Total credit items	38,903

Debit balances		
Debit balances in customers' cash and margin accounts excluding unsecured accounts and accounts doubtful of collection net of deductions pursuant to Rule 15c3-3[‡]		38,988
Securities borrowed to effectuate short sales by customers and securities borrowed to make delivery on customers' securities failed to deliver		1,318
Failed to deliver of customers' securities not older than 30 calendar days (including debit balances in continuous net settlement accounts)		14,782
Other[‖]		438
Gross debits		55,526
Less 3 percent charge		1,666
Total debit items[‡]		53,860
Reserve computation[‡]		
Excess of total debits over total credits		$14,957
Required deposit		None
Reconciliation with Company's computation[#] (included in part II of Form X-17A-5 as of December 31, 20X1)		
Excess debits as reported in Company's part II FOCUS report		$15,496
Nonregulated commodity margin deposits erroneously excluded from the Company's computation	$322	
Other items, net	217	(539)
Excess debits per the preceding computation		$14,957

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* Practitioners should consider the impact of recently issued accounting and regulatory pronouncements when preparing or auditing this supplementary schedule.

† Would be seven calendar days if the broker or dealer had elected the alternative net capital requirement under Rule 15c3-1(f).

‡ Those firms calculating net capital under the basic method must reduce debit balances in customer accounts by 1 percent, whereas those calculating net capital under the alternative method are required to reduce total debits by 3 percent.

‖ This caption may only include those interpretive items that do not belong in the captions specified by the rule.

\# If there are no material differences from the Company's computation and a reconciliation is not included, a statement to that effect is required. The following statement can be used to satisfy this requirement:

Note: There are no material differences between the preceding computation and the Company's corresponding unaudited part II of Form X-17A-5 as of December 31, 20X1.

This note can be placed at the end of this schedule or on every page of the schedule.

Schedule III

Standard Stockbrokerage Co., Inc.

Information Relating to Possession or Control Requirements Under Rule 15c3-3 of the Securities and Exchange Commission[*]

(Standard Stockbrokerage Co., Inc. only)

(*Dollars in Thousands)*

As of December 31, 20X1

1. Customers' fully paid and excess margin securities not in the respondent's possession or control as of the report date (for which instructions to reduce to possession or control had been issued as of the report date but for which the required action was not taken by respondent within the time frames specified under Rule 15c3-3):[†]	$18
A. Number of items	2
2. Customers' fully paid securities and excess margin securities for which instructions to reduce to possession or control had not been issued as of the report date, excluding items arising from "temporary lags which result from normal business operations" as permitted under Rule 15c3-3.[‡]	$39
A. Number of items	5

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[*] Practitioners should consider the impact of recently issued accounting and regulatory pronouncements when preparing or auditing this supplementary schedule.

[†] If the customers' fully paid securities are subsequently reduced to possession or control, a statement to that effect should be included.

[‡] In some instances, it may be impractical to determine the number of items in response to item 2. It may also be impractical to determine whether the Company has subsequently issued instructions to reduce those items to possession or control or to determine that such instructions were acted on.

Schedule IV

Standard Stockbrokerage Co., Inc.

Schedule of Segregation Requirements and Funds in Segregation for Customers' Regulated Commodity Futures and Options Accounts*

(*Dollars in Thousands)*

As of December 31, 20X1

Segregation requirements	
Net ledger balance:	
Cash	$976
Securities (at market)	784
Net unrealized profit (loss) in open futures contracts	(367)
Exchange traded options	
Add: market value of open option contracts purchased on a contract market	143
Deduct: market value of open option contracts granted (sold) on a contract market	(129)
Net equity (deficit)	1,407
Add: accounts liquidating to a deficit and accounts with debit balances with no open trades	78
Amount required to be segregated	1,485
Funds on deposit in segregation	
Deposited in segregated funds bank accounts:	
Cash	105
Securities representing investments of customers' funds (at market)	141
Securities held for customers in lieu of cash margins (at market)	784
Margins on deposit with clearing organizations of contract markets:	
Cash	170
Securities representing investments of customers' funds (at market)	489
Settlement due from (to) contract market clearing organization	(28)
Exchange traded options:	
Add: unrealized receivables for option contracts purchased on contract markets	143
Deduct: unrealized obligations for option contracts granted (sold) on contract markets	(129)
Net equities with other FCMs	37
Total amount in segregation	1,712
Excess funds (insufficiency) in segregation	$227

* Practitioners should consider the impact of recently issued accounting and regulatory pronouncements when preparing or auditing this supplementary schedule.

Chapter 5

Auditing Considerations[1]

General Considerations[*]

5.01 The primary purpose of a financial statement audit of a broker-dealer is to express an opinion on management's financial statements. As discussed in the "Regulatory Environment" section of this chapter, the auditor is also required to report on the adequacy of the broker-dealer's internal control in accordance with Securities and Exchange Commission (SEC) Rule 17a-5(g)(1) and on its compliance with specific rules addressing financial responsibility and recordkeeping. Auditors of issuer broker-dealers are also required to audit and report on management's assessment of the company's internal control over financial reporting in conjunction with their audit of the company's financial statements. Public Company Accounting Oversight Board (PCAOB) guidance, as found in Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Standards, AU-P sec. 320), establishes requirements and provides directions that apply when an auditor is engaged to audit both an issuer's financial statements and management's assessment of the effectiveness of internal control over financial reporting. Chapter 6, "Internal Control," of this guide discusses the auditor's understanding of internal control in the audit of a broker-dealer's financial statements and provides an overview of the types of control and monitoring activities that are unique to brokers-dealers. This guide is not intended to provide guidance to auditors on how to comply with the requirements of Auditing Standard No. 5 (AU-P sec. 320) although it highlights, as appropriate, additional requirements imposed by that standard. The objective of the auditing section of this guide is to assist the independent auditor[2] in auditing the financial statements of broker-dealers in accordance with both AICPA *Professional Standards*, referred to as generally accepted auditing standards (GAAS), and *PCAOB Professional Standards* and in complying with regulatory requirements discussed in the subsequent paragraphs. The term *audit* generally refers to the audit of financial statements

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[1] Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface). Although audits required under Section 17(e) of the Securities Exchange Act of 1934 (as amended by the Sarbanes-Oxley Act of 2002), for fiscal years ending after December 31, 2008, must be conducted by a firm that is registered with the Public Company Accounting Oversight Board (PCAOB), the requirement does not change the auditor requirements outlined in Rule 17a-5(g), which requires that audits of nonissuer broker-dealers be made in accordance with generally accepted auditing standards (GAAS). See also paragraphs 5.03–.05 (and related footnotes) for more information and for recent developments regarding this issue.

As applicable, this chapter contains referencing to either the AICPA or the PCAOB professional standards. Refer to the preface for more information on referencing.

[*] In February 2009, Statement on Auditing Standards (SAS) No. 116, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722), was issued. This SAS amends AU section 722, *Interim Financial Information*, to accommodate reviews of interim financial information of nonissuers, including companies offering securities pursuant to Securities and Exchange Commission (SEC) Rule 144A or participating in private equity exchanges. It is effective for reviews of interim financial information for interim periods beginning after December 15, 2009.

[2] As noted in paragraph 5.03, financial statements of nonpublic broker-dealers filed with the SEC must be certified by a PCAOB registered public accounting firm. The term "independent auditor," as used in this guide, assumes that the firm is registered with PCAOB, as required.

unless it is indicated that the discussion pertains to the integrated audit or audit of internal controls. This section of the guide provides guidance, primarily on the application of the standards of fieldwork. Specifically, this section provides guidance on the risk assessment process (which includes, among other things, obtaining an understanding of the entity and its environment, including its internal control) and general auditing considerations for broker-dealers.

5.02 As part of preliminary audit engagement activities, the auditor should perform procedures regarding the acceptance or continuance of the client relationship and the specific audit engagement. One of these considerations may include ascertaining that the audit engagement can be conducted in accordance with GAAS or PCAOB standards, as applicable. If he or she is satisfied that an audit can be conducted, the auditor must plan the audit so that it is responsive to the assessment of the risks of material misstatement based on the auditor's understanding of the entity and its environment, including its internal control. The auditor and the broker-dealer should establish a clear understanding regarding the scope of services to be performed and should document the understanding through a written communication (see paragraphs 5.18–.19 titled "Establishing an Understanding With the Client"). The nature, timing, and extent of procedures to be performed and the type of reports to be issued are based on the scope of the services required. In addition, the volatility and level of activity of some accounts in the broker-dealer affect the auditor's decision about performing interim substantive tests, such as confirming balances.

Auditor Requirements

5.03 Financial statements of nonpublic broker-dealers filed with the SEC for fiscal years ending after December 31, 2008, must be certified by a PCAOB registered public accounting firm. The auditor must be registered with the PCAOB as of the date of the auditor's report. Registration with the PCAOB subjects all registered firms, including those that do not audit issuers, to comply with the PCAOB's annual and special reporting requirements, including payment of an annual fee.[†]

5.04 PCAOB registration does not change the auditor requirements outlined in Rule 17a-5(g), which requires that audits of nonissuer broker-dealers be performed in accordance with GAAS. (See footnote 1 for more information.) In addition, under current law as of July 1, 2010, the registration of the auditor does not subject audits of nonpublic broker-dealers to PCAOB inspection.[‡]

5.05 Notwithstanding the requirement to register with the PCAOB, auditors of nonissuer broker-dealers are not subject to the PCAOB's independence rules, including the PCAOB rules on contingent fees and tax services. However, auditors of nonissuer broker-dealers and investment advisers continue to be subject to certain SEC independence requirements, including restrictions on financial and employment relationships, contingent fees and

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[†] The PCAOB has made available information related to the registration of auditors of broker-dealers. *Staff Questions and Answers, Registration of Broker-Dealer Auditors*, issued in January 2010, and PCAOB Release 2003-011D, *Frequently Asked Questions Regarding Registration with the Board*, issued in April 2010, are available on the PCAOB website.

[‡] The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) amends the Sarbanes-Oxley Act of 2002 to give the PCAOB full oversight authority over auditors of all broker-dealers, including standard setting, inspection, and enforcement. See the preface for more information on the Dodd-Frank Act, including information related to PCAOB oversight of auditors of broker-dealers.

nonaudit services. Accordingly, such auditors should not perform bookkeeping services for these audit clients, including maintaining or preparing the client's accounting records and financial statements. Nonissuer broker-dealers and investment advisers, however, are not subject to the SEC's partner rotation and compensation requirements because such rules only pertain to *audits of issuers* (as defined by the Sarbanes-Oxley Act of 2002). For additional information on SEC independence rules and frequently asked questions on PCAOB registration of auditors of nonpublic broker-dealers, please visit www.sec.gov/info/accountants/independref.shtml and http://sec.gov/divisions/marketreg/faq-pcaobregbdauditors.htm.

Regulatory Environment[3]

5.06 The regulatory environment has a major effect on the audit of a broker-dealer because of the requirements that the auditor report on the adequacy of the broker-dealer's internal control in accordance with SEC Rule 17a-5(g)(1) and on its compliance with specific rules addressing financial responsibility and recordkeeping. Accordingly, certain tests of controls are performed even if the auditor would not otherwise choose to do so as part of the audit of financial statements. See chapter 6 of this guide for more information.

5.07 The objectives of the annual audit of the financial statements of a broker-dealer are discussed in SEC Rule 17a-5. The rule requires that the audit be made in accordance with GAAS and include a review of the accounting system, the internal accounting control and procedures for safeguarding securities, including appropriate tests for the period since the prior audit date. Rule 17a-5 requires the audit to include all procedures necessary to enable the auditor to express an opinion on the following:

- The statements of financial condition, results of operations, and cash flows
- The computation of net capital under SEC Rule 15c3-1
- The computation for determination of reserve requirements for broker-dealers under SEC Rule 15c3-3
- Information relating to the possession or control requirements under SEC Rule 15c3-3

5.08 SEC Rule 17a-5 recommends that auditors consider synchronizing the application of auditing procedures and performing tests in certain areas simultaneously.

5.09 Accordingly, although auditors may exercise their professional judgment in making those decisions, they may be expected to justify a choice not to synchronize certain substantive tests (such as confirming customer transactions and open or unsettled transactions with other broker-dealers and transfer agents, and substantiating stock record positions by counting securities or through other appropriate means).

5.10 In planning and performing the audit of financial statements, the auditor should obtain reasonable assurance that any material inadequacies existing at the audit report date in the following areas would be disclosed:

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[3] See chapter 3, "Regulatory Considerations," of this guide for information on amendments to Rule 206(4)-2 of the Investment Advisors Act of 1940 related to a broker-dealer that is also a registered investment adviser.

- The accounting system
- Internal control
- Procedures for safeguarding securities
- The practices and procedures whose review is specified by SEC Rule 17a-5

5.11 In addition, as specific objectives, the audit of financial statements should include reviews of the practices and procedures followed by the broker-dealer, as applicable, in the following ways:

- Making the periodic computations, pursuant to SEC Rule 17a-3(a)(11), of aggregate indebtedness or aggregate debit items under the alternative method and net capital under SEC Rule 15c3-1 and the reserve required by SEC Rule 15c3-3
- Making the quarterly securities examinations, counts, verifications and comparisons, and recording of differences required by SEC Rule 17a-13
- Complying with the requirements for prompt payment for securities under Federal Reserve Regulation T (Regulation T) of the Board of Governors of the Federal Reserve System
- Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers, as required by SEC Rule 15c3-3

5.12 This review should include a determination as to the adequacy of procedures described in the records required to be maintained pursuant to SEC Rule 15c3-3(d)(4).

5.13 For a broker-dealer that is exempt from Rule 15c3-3, the auditor should ascertain that the conditions of the exemption were being complied with as of the audit report date and that no facts came to the auditor's attention indicating that the exemption had not been complied with during the period since the last audit.

5.14 A material inadequacy in the accounting system, internal accounting controls, procedures for safeguarding securities, and practices and procedures referred to in paragraph (g)(1) of SEC Rule 17a-5 that is expected to be reported under these audit objectives includes any condition that has contributed substantially to or, if appropriate corrective action is not taken, could reasonably be expected to cause any of the following:

a. Inhibit a broker-dealer from promptly completing securities transactions or promptly discharging its responsibilities to customers, other broker-dealers, or creditors

b. Result in material financial loss

c. Result in material misstatements in the broker-dealer's financial statements

d. Result in violations of the SEC's recordkeeping or financial responsibility rules to an extent that could reasonably be expected to result in the conditions described in SEC Rule 17a-5(g)(3)

Planning and Other Auditing Considerations

5.15 The objective of an audit of broker-dealer's financial statements is to express an opinion on whether its financial statements are presented fairly, in all material respects, and in conformity with generally accepted accounting principles (GAAP) or other comprehensive basis of accounting. To accomplish that objective, the independent auditor's responsibility is to plan and perform the audit to obtain reasonable assurance (a high, but not absolute, level of assurance) that material misstatements, whether caused by errors or fraud, are detected. This section addresses general planning considerations and other auditing considerations relevant to broker-dealers.

Audit Planning

5.16 The first standard of field work states, "The auditor must adequately plan the work and must properly supervise any assistants." AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance on the considerations and activities applicable to planning and supervision of an audit conducted in accordance with GAAS, including appointment of the independent auditor; preliminary engagement activities; establishing an understanding with the client; preparing a detailed, written audit plan; determining the extent of involvement of professionals with specialized skills; and communicating with those charged with governance and management. Audit planning also involves developing an overall audit strategy for the expected conduct, organization, and staffing of the audit. The nature, timing, and extent of planning vary with the size and complexity of the entity, and with the auditor's experience with the entity and understanding of the entity and its environment, including its internal control.

5.17 Paragraph .03 of AU section 311 states that the auditor must plan the audit so that it is responsive to the assessment of the risks of material misstatement based on the auditor's understanding of the entity and its environment, including its internal control. Planning is not a discrete phase of the audit, but rather an iterative process that begins with engagement acceptance and continues throughout the audit as the auditor performs audit procedures and accumulates sufficient appropriate audit evidence to support the audit opinion.

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
>
> When performing an integrated audit of financial statements and internal control over financial reporting in accordance with PCAOB standards (subsequently referred to as *integrated audit*), the auditor should refer to paragraph 9 of Auditing Standard No. 5 (AU-P sec. 320 par. .09) regarding planning considerations in addition to the planning considerations discussed in AU section 311.

Establishing an Understanding With the Client

5.18 AU section 311 states that the auditor should establish an understanding with the client regarding the services to be performed for each engagement. This understanding should be documented through a written communication with the broker-dealer, for example, an engagement letter. The understanding should include the objectives of the engagement, the responsibilities of management and the auditor, and any limitations of the engagement.

Considerations for Audits Performed in Accordance with PCAOB Standards

When performing an integrated audit, the auditor should refer to paragraph .06 of AU-P section 310, *Appointment of the Independent Auditor* (AICPA, *PCAOB Standards and Related Rules*, Standards), which includes requirements specific to the integrated audit related to (1) the objective of the audit, (2) the responsibility of the auditor for conducting the audit in accordance with PCAOB standards, and (3) the responsibility of the auditor for communicating certain matters in writing to various parties, including management.

5.19 AU section 311 also identifies specific matters that generally would be addressed in the understanding with the client, and other contractual matters an auditor might wish to include in the understanding. Paragraph .46 of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1), provides guidance on establishing an understanding with the client regarding the services to be performed for attest engagements.

Audit Risks

5.20 AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), states that audit risk is a function of the risk that the financial statements prepared by management are materially misstated and the risk that the auditor will not detect such material misstatement. The auditor should consider audit risk in relation to the relevant assertions related to individual account balances, classes of transactions, and disclosures and at the overall financial statement level.

5.21 At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of (*a*) the risks of material misstatement (consisting of inherent risk and control risk) and (*b*) detection risk. Paragraph .23 of AU section 312 states that an auditor should assess the risks of material misstatement at the relevant assertion level as a basis for further audit procedures (tests of controls or substantive audit procedures). Therefore, it is not acceptable to simply deem risk to be "at the maximum." This assessment may be in qualitative terms such as high, medium, and low, or in quantitative terms such as percentages. The risks are described as follows:

- *Inherent risk* is the susceptibility of a relevant assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. Inherent risk is greater for some assertions and related account balances, classes of transactions, and disclosures than for others (for example, the inherent risk for cash and securities in the vault is greater than the inherent risk for plant assets). However, other factors (such as an impending business failure) may typically increase the inherent risk for all assertions and related account balances, classes of transactions, and disclosures. Financial statement balances derived from accounting estimates pose greater risk than do those derived from relatively routine, factual data.
- *Control risk* is the risk that a misstatement that could occur in a relevant assertion and that could be material, either individually or when aggregated with other misstatements, will not be

prevented or detected on a timely basis by the broker-dealer's internal control. That risk is a function of the effectiveness of the design and operation of internal control in achieving the broker-dealer's objectives relevant to preparation of the entity's financial statements. Some control risk will always exist because of the inherent limitations of internal control.

- *Detection risk* is the risk that the auditor will not detect a misstatement that exists in a relevant assertion that could be material, either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. Detection risk cannot be reduced to zero because the auditor does not examine 100 percent of an account balance or a class of transactions and because of other factors. Such other factors include the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results. These other factors might be addressed through adequate planning, proper assignment of personnel to the engagement team, the application of professional skepticism, supervision and review of the audit work performed, and supervision and conduct of a firm's audit practice in accordance with appropriate quality control standards.

5.22 The way the auditor should consider the component risks and combine them involves professional judgment and depends on the auditor's approach or methodology. It can easily be shown that there is an inverse relationship between inherent risk, control risk, and detection risk (that is, between the first two risks and the third). Thus, the lower the inherent and control risk, the greater the detection risk the auditor can accept.

5.23 In considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. Risks of this nature often relate to the entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. Such risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control.

5.24 In planning an audit, the auditor must consider audit risk and must determine a materiality level for the financial statements as a whole. In the audit of a broker-dealer, the effect of the regulatory environment, changes in that environment, and the expectations of the client, its customers, and regulators on both audit risk and materiality (materiality is discussed in the subsequent paragraph) are likely to be important considerations. In assessing the risks of material misstatement, certain aspects of the broker-dealer's operations are usually subject to a greater level of audit risk than others. Some areas to consider are the effectiveness of the broker-dealer's internal control, materiality, inherent risk, and the possible need to synchronize the timing of certain auditing procedures. In the chart titled "Securities Broker-Dealers' Auditing Considerations" at the end of this chapter, see the "Regulatory" section under the column heading, "Audit Areas."

5.25 The auditor's judgment about the level of audit risk may affect engagement staffing, the extent of supervision, and the scope of the audit. For instance, for an aspect of the audit that is judged to involve high risk, the auditor might consider staffing the engagement with auditors having relevant experience in auditing the aspect assessed to have high risk and increasing the nature, timing, and extent of the audit work.

Planning Materiality

5.26 Paragraph .04 of AU section 312 notes that information is material if, in the light of the surrounding circumstances, the magnitude of an omission or misstatement of information makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by its omission or misstatement. When making materiality judgments, the decision will be influenced by both the circumstances of the broker-dealer as well as the information needs of those who rely on the financial statements. In accordance with AU section 312, the auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
>
> When performing an integrated audit, refer to paragraph 20 of Auditing Standard No. 5 (AU-P sec. 320 par. .20) regarding materiality considerations.

5.27 In accordance with paragraph .27 of AU section 312, the auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall audit strategy for the audit.[4] The auditor may make an initial judgment regarding materiality levels in planning the audit and may utilize another level in evaluating the audit findings. The discrepancy in levels may be due to information that was obtained during the course of the audit, as well as overall changing circumstances. The auditor often may apply a percentage to a chosen benchmark as a step in determining materiality for the financial statements taken as a whole. Some other common factors used by auditors in ascertaining the materiality level for a broker-dealer include the following:

- The absolute or relative size of the misstatement
- The nature of the misstatement
- The cumulative effects of any and all known or likely misstatements
- Any uncertainty surrounding the misstatement

Tolerable Misstatement

5.28 The initial determination of materiality is made for the financial statement taken as a whole. However, the auditor should allow for the

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[4] SEC Staff Accounting Bulletin (SAB) No. 99, *Materiality*, addresses the application of materiality thresholds in the preparation and audit of financial statements filed with the SEC. Among other matters, SAB No. 99 addresses the evaluation of misstatements discovered in the financial reporting and auditing processes. SAB No. 99 does not create new standards or definitions for materiality, but reaffirms the concepts of materiality as expressed in the accounting and auditing literature.

possibility that some misstatements of lesser amounts than the materiality levels could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor should determine one or more levels of tolerable misstatement. Paragraph .34 of AU section 312 defines *tolerable misstatement* (or *tolerable error*) as the maximum error in a population, for example, the class of transactions or account balance, that the auditor is willing to accept. Such levels of tolerable misstatement are normally lower than the materiality levels.

Qualitative Aspects of Materiality

5.29 As indicated previously, judgments about materiality include both quantitative and qualitative information. As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

5.30 Qualitative considerations also influence the auditor in reaching a conclusion about whether misstatements are material. Paragraph .60 of AU section 312 provides qualitative factors that the auditor may consider relevant in determining whether misstatements are material.

Illegal Acts

5.31 AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), provides guidance on the nature and extent of the considerations the auditor should give to the possibility of illegal acts by clients. The term *illegal acts*, for the purposes of AU section 317, relates to violations of laws or government regulations. Illegal acts may vary considerably in their relation to the financial statements. The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. AU section 317 provides that the auditor's responsibility to detect and report misstatements resulting from illegal acts that have a direct and material effect on the determination of financial statement amounts is the same as that for material fraud as described in AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1). That is, the auditor should design the audit to obtain reasonable assurance of detecting illegal acts that have a direct and material effect on the financial statements.

5.32 Broker-dealers may be affected by many laws or regulations, including those related to fair practice, securities trading, underwriting, and customer transactions. The laws and regulations generally relate more to a broker-dealer's operating aspects than to its financial and accounting aspects, and their financial statement effects are indirect. Normally, an audit of financial statements in accordance with GAAS or PCAOB standards does not include audit procedures specifically designed to detect illegal acts that have an indirect effect on the financial statements. However, the auditor may become aware of the possibility of such acts during the course of performing procedures for the purpose of forming an opinion on the financial statements. AU section 317 provides guidance with respect to the auditor's response to such possible illegal acts.

Use of Assertions in Obtaining Audit Evidence

5.33 Paragraphs .14–.19 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), discuss the use of assertions in obtaining audit evidence. In representing that the financial statements are fairly presented in accordance with GAAP, management implicitly or explicitly makes assertions regarding the recognition, measurement, and disclosure of information in the financial statements and related disclosures. Assertions used by the auditor fall into the following categories:

Categories of Assertions

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Occurrence/ Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred.
Rights and Obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	Disclosed events and transactions pertain to the entity.
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.
Accuracy/ Valuation and Allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts.
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Classification and Understandability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described, and information in disclosures is expressed clearly.

5.34 The auditor should use relevant assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor should use relevant assertions in assessing risks by considering the different types of potential misstatements that may occur, and then designing further audit procedures that are responsive to the assessed risks.

Understanding the Entity, Its Environment, and Its Internal Control

5.35 AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), establishes requirements and provides guidance about implementing the second standard of field work, as follows:

> The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

5.36 Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. Throughout this process, the auditor should also consider the guidance in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1). See paragraphs 5.77–.79 for additional guidance pertaining to AU section 316.

5.37 This section addresses the unique aspects of broker-dealers that may be helpful in developing the required understanding of the entity, its environment, and its internal control.

Risk Assessment Procedures

5.38 As described in AU section 326, audit procedures performed to obtain an understanding of the entity and its environment, including its internal control, and to assess the risks of material misstatement at the financial

statement and relevant assertion levels are referred to as *risk assessment procedures*. Paragraph .21 of AU section 326 states that the auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion and must be supplemented by further audit procedures in the form of tests of controls, when relevant or necessary, and substantive procedures.

5.39 In accordance with paragraph .06 of AU section 314, the auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

a. Inquiries of management and others within the entity

b. Analytical procedures (refer to the subsequent section titled "Analytical Procedures" for additional guidance)

c. Observation and inspection

See paragraphs .06–.13 of AU section 314 for additional guidance on risk assessment procedures.

Discussion Among the Audit Team

5.40 In obtaining an understanding of the entity and its environment, including its internal control, AU section 314 states that there should be discussion among the audit team. In accordance with paragraph .14 of AU section 314, the members of the audit team, including the auditor with final responsibility for the audit, should discuss the susceptibility of the entity's financial statements to material misstatements. This discussion could be held concurrently with the discussion among the audit team that is specified by AU section 316 to discuss the susceptibility of the entity's financial statements to fraud.

Understanding of the Entity and Its Environment

5.41 AU section 314 requires auditors to obtain an understanding of the entity and its environment, including its internal control. In accordance with paragraph .04 of AU section 314 the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment, including its internal control. The auditor's primary consideration is whether the understanding that has been obtained is sufficient (1) to assess risks of material misstatement of the financial statements and (2) to design and perform further audit procedures (tests of controls and substantive tests).

5.42 The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

a. Industry, regulatory, and other external factors

b. Nature of the entity

c. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements

d. Measurement and review of the entity's financial performance

e. Internal control, which includes the selection and application of accounting policies (see the following section for further discussion)

Refer to appendix A of AU section 314 for examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to categories *(a)–(d)*. Refer to chapters 1–3 of this guide for

background on the securities industry, including regulatory considerations that may be helpful in developing an understanding of a broker-dealer.

Understanding of Internal Control

5.43 AU section 314 defines *internal control* and states that the auditor should obtain an understanding of the five components of internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. Obtaining an understanding of internal control as well as key control and monitoring activities of a broker-dealer are described in chapter 6 of this guide.

5.44 As discussed in paragraph 5.01, this guide is not intended to provide guidance to auditors on how to comply with the requirements of Auditing Standard No. 5 (AU-P sec. 320) although it highlights, as appropriate, additional requirements imposed by that standard.

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
>
> Auditors of broker-dealers that are issuers are also required to attest to and report on management's assessment of the company's internal control over financial reporting in conjunction with their audit of the company's financial statements in accordance with Auditing Standard No. 5 (AU-P sec. 320).

Assessment of Risks of Material Misstatement and the Design of Further Audit Procedures

5.45 As discussed previously, risk assessment procedures allow the auditor to gather the information necessary to obtain an understanding of the entity and its environment, including its internal control. This knowledge provides a basis for assessing the risks of material misstatement of the financial statements. These risk assessments are then used to design further audit procedures, such as tests of controls, substantive tests, or both. This section provides guidance on assessing the risks of material misstatement and how to design further audit procedures that effectively respond to those risks.

Assessing the Risks of Material Misstatement

5.46 Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. This requirement provides a link between the auditor's assessment of risk, including his or her consideration of fraud, and the audit procedures performed in response to those assessed risks. For this purpose, the auditor should

a. identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and considering the classes of transactions, account balances, and disclosures in the financial statements,

b. relate the identified risks to what can go wrong at the relevant assertion level,

c. consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements, and

d. consider the likelihood that the risks could result in a material misstatement of the financial statements.

5.47 The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the assessment of the risks of material misstatement at the relevant assertion level as the basis to determine the nature, timing, and extent of further audit procedures to be performed.

Identification of Significant Risks

5.48 As part of the assessment of the risks of material misstatement, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as *significant risks*). One or more significant risks normally arise on most audits. In exercising this judgment, the auditor should consider inherent risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration. Refer to paragraphs .45 and .53 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), for further audit procedures pertaining to significant risks.

Designing and Performing Further Audit Procedures

5.49 AU section 318 provides guidance about implementing the third standard of field work, as follows:

> The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

5.50 To reduce audit risk to an acceptably low level, the auditor (1) should determine overall responses to address the assessed risks of material misstatement at the financial statement level and (2) should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor's further audit procedures and the assessed risks. The overall responses and the nature, timing, and extent of the further audit procedures to be performed are matters for the professional judgment of the auditor and should be based on the auditor's assessment of the risks of material misstatement.

5.51 With respect to the extent and timing of auditing procedures, SEC Rule 17a-5 also states, in part

> The extent and timing of audit procedures are matters for the independent public accountant to determine on the basis of his (or her) review and evaluation of existing internal controls and other audit procedures performed in accordance with generally accepted auditing standards and the audit objectives set forth in paragraph (g) of this section. In determining the extent of testing, consideration shall be

given to the materiality of an area and the possible effect on the financial statements and schedules of a material misstatement in a related account. The performance of auditing procedures involves the proper synchronization of their application and thus comprehends the need to consider simultaneous performance of procedures in certain areas such as, for example, securities counts, transfer verification and customer and broker confirmation in connection with verification of securities positions.

5.52 Certain auditing procedures (including security counts and related confirmations) may be performed at a date other than the date of the financial statements. AU section 318 provides guidance on factors to be considered before applying substantive tests to details of asset and liability accounts at a date prior to the date of the financial statements. The extent of an audit procedure is determined by the judgment of the auditor after considering the tolerable misstatement, the assessed risks of material misstatement, and the degree of assurance that auditor plans to obtain. Guidance concerning the timing of tests of controls in connection with the audit of financial statements is provided in paragraphs .35–.45 of AU section 318.

Considerations for Audits Performed in Accordance with PCAOB Standards

When performing an integrated audit, the auditor should refer to paragraphs 42–61 of Auditing Standard No. 5 (AU-P sec. 320 par. .42–.61) which provide directions about the nature, timing, and extent of testing of the design and operating effectiveness of internal control over financial reporting.

In addition, the audit scope for review and testing of procedures relative to net capital, quarterly security counts, and compliance with Regulation T and Rule 15c3-3 should be sufficient to provide reasonable, but not absolute, assurance that any material inadequacies existing at the audit date would be disclosed as prescribed in Rule 17a-5.

Overall Responses

5.53 The auditor's overall responses to address the assessed risks of material misstatement at the financial statement level may include emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence, assigning more experienced staff or those with specialized skills or using specialists, providing more supervision, or incorporating additional elements of unpredictability in the selection of further audit procedures to be performed. Additionally, the auditor may make general changes to the nature, timing, or extent of further audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date.

Further Audit Procedures

5.54 Further audit procedures provide important audit evidence to support an audit opinion. These procedures consist of tests of controls and substantive tests. The nature, timing and extent of the further audit procedures to be performed by the auditor should be based on the auditor's assessment of risks of material misstatement at the relevant assertion level.

5.55 In some cases, an auditor may determine that performing only substantive procedures is appropriate. However, the auditor may determine that

a combined audit approach using both tests of the operating effectiveness of controls and substantive procedures is an effective audit approach.

5.56 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level.

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
>
> When performing an integrated audit, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on management's assessment of the company's internal control over financial reporting when concluding on the effectiveness of controls for the purpose of assessing *control risk*. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies. (Appendix B paragraph B5 of Auditing Standard No. 5 [AU-P sec. 320])
>
> If, during the audit of internal control over financial reporting, the auditor identifies a deficiency, he or she should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an appropriately low level. (Appendix B paragraph B6 of Auditing Standard No. 5 [AU-P sec. 320])
>
> In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of all substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. (Appendix B paragraph B8 of Auditing Standard No. 5 [AU-P sec. 320])

5.57 Regardless of the audit approach selected, and the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.

5.58 The auditor's substantive procedures should include the following audit procedures related to the financial statement reporting process:

- Agreeing the financial statements, including their accompanying notes, to the underlying accounting records
- Examining material journal entries and other adjustments made during the course of preparing the financial statements

The nature and extent of the auditor's examination of journal entries and other adjustments depend on the nature and complexity of the entity's financial reporting system and the associated risks of material misstatement.

5.59 Regulatory requirements have a major effect on the audit of a broker-dealer because the auditor is required to issue a report on the adequacy of the broker-dealer's internal control in accordance with SEC Rule 17a-5(g)(1) and on its compliance with specific rules addressing financial responsibility and recordkeeping. Accordingly, some tests of controls are normally performed even if the auditor does not rely on internal control for purposes of rendering an opinion on the financial statements.

5.60 There is not necessarily a one-to-one relationship between audit objectives and audit procedures. Some procedures may relate to more than one objective. A combination of procedures may be needed to achieve a single objective. The chart titled "Securities Broker-Dealers' Auditing Considerations" at the end of this chapter, provides illustrations of audit assertions, audit objectives, and substantive tests/tests of controls. The chart is intended neither to be all-inclusive nor to suggest that specific audit objectives or substantive procedures be applied.

5.61 The chart is arranged by broad audit objectives. Such classifications may be useful in the evaluation process, but the classifications are of secondary importance. Some specific objectives may achieve more than one broad objective. A number of the objectives may not be relevant to a particular broker-dealer because of the nature of its operations or the absence of certain types of transactions.

5.62 Refer to paragraphs 5.153–.193 in the section titled "Substantive Audit Procedures" in the later part of this chapter for specific guidance on the more significant auditing procedures that the independent auditor may consider in the audits of broker-dealers.

Audit Sampling

5.63 AU section 350, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1), provides guidance for planning, performing, and evaluating both statistical and nonstatistical audit samples. The statement also includes discussions intended to enhance professional judgment in assessing sampling risk, planning samples, sample selection, and performance and evaluation. The AICPA Audit Guide *Audit Sampling* presents recommendations to help auditors apply audit sampling in accordance with AU section 350.

5.64 As with any audit, sampling can be utilized in a broker-dealer audit for tests of controls or verifying account balances. Some areas in which sampling may be used in a broker-dealer audit include the following:

- *Verification of customer balances*. The auditor may not need to confirm all account balances; thus sampling would be appropriate.
- *Verification of the stock record*. Sampling may be used in the following three ways:
  - — To select securities maintained on the client's premises for physical inspection and counting
  - — To confirm securities held by various depositories
  - — To test clearing organization reconciliations, confirming street-side accounts (such as fails, stock loan, stock borrow, securities purchased under agreements to resell and securities sold under agreements to repurchase), or reviewing suspense accounts
- *Letter on internal control*. Sampling may be used in the following two ways:
  - — To determine the adequacy of the broker-dealers' practices and procedures relating to performing the net capital and reserve requirement computations, security counts, and compliance with Regulation T

  - — To obtain and maintain physical possession or control of required securities during the year

- *Net capital computation*. Sampling may be used to test the accuracy and completeness of the broker-dealer's schedule of aged fails-to-receive and fails-to-deliver and short security count differences, to test the market values of firm inventory and the related regulatory haircuts in the broker-dealer's net capital computation as of the balance sheet date.
- *Reserve requirement computation*. Sampling may be used to test the accuracy and completeness of the broker-dealer's allocation of securities between the customer and the firm, and to review adjustments made to certain balance sheet accounts that were previously tested by the auditor.
- *Possession or control requirements*. Sampling may be used to test the accuracy and completeness of information regarding violations, if any, of possession or control requirements as of the balance sheet date.

Evaluating Misstatements[5]

5.65 Based on the results of audit procedures, the auditor may identify misstatements in accounts or notes to the financial statements. Paragraph .42 of AU section 312 states that auditors must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial and communicate them to the appropriate level of management on a timely basis. AU section 312 further states that auditors must consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity. This consideration includes, among other things, the effect of misstatements related to prior periods.

5.66 For detailed guidance on evaluating audit findings and audit evidence, refer to AU section 312 and AU section 326, respectively.

Audit Documentation

Audits Conducted in Accordance With GAAS

General

5.67 AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), provides guidance on audit documentation. The guidance states that the auditor must prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusion reached. Audit documentation

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[5] SEC SAB No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, can be found on the SEC website at www.sec.gov/interps/account.shtml for more information on financial statement misstatements.

a. provides the principal support for the representation in the auditor's report that the auditor performed the audit in accordance with generally acceptable auditing standards, and

b. provides the principal support for the opinion expressed regarding the financial information or the assertion to the effect that an opinion cannot be expressed.

5.68 Audit documentation is an essential element of audit quality. Although documentation alone does not guarantee audit quality, the process of preparing sufficient and appropriate documentation contributes to the quality of an audit.

5.69 Audit documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. Audit documentation, also known as working papers or workpapers, may be recorded on paper or on electronic or other media. When transferring or copying paper documentation to another media, the auditor should apply procedures to generate a copy that is faithful in form and content to the original paper document.

5.70 Audit documentation includes, for example, audit plans, analyses, issues memoranda, summaries of significant findings or issues, letters of confirmation and representation, checklists, abstracts or copies of important documents, correspondence (including e-mail) concerning significant findings or issues, and schedules of the work the auditor performed. Abstracts or copies of the entity's records (for example, significant and specific contracts and agreements) should be included as part of the audit documentation if they are needed to enable an experienced auditor to understand the work performed and conclusions reached. The audit documentation for a specific engagement is assembled in an audit file.

Form, Content, and Extent of Audit Documentation

5.71 The auditor should prepare audit documentation that enables an experienced auditor, having no previous connection to the audit, to understand (paragraph .10 of AU section 339)

a. the nature, timing, and extent of auditing procedures performed to comply with Statements on Auditing Standards (SASs) and applicable legal and regulatory requirements,

b. the results of the audit procedures performed and the audit evidence obtained,

c. the conclusions reached on significant matters, and

d. that the accounting records agree or reconcile with the audited financial statements or other audited information.

Dating of the Auditor's Report[6]

5.72 Paragraph .23 of AU section 339 states that the auditor's report should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion. Among other things,

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[6] Practice Alert No. 07-1, *Dating of the Auditor's Report and Related Practical Guidance* (AICPA, *Technical Practice Aids*, PA sec. 16,290), provides guidance regarding the application of certain provisions of AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), primarily related to dating the auditor's report.

sufficient appropriate audit evidence includes 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 it has taken responsibility for them. This ordinarily will result in a report date that is close to the date the auditor grants the entity permission to use the auditor's report in connection with the financial statements (report release date). Delays in releasing the report may require the auditor to perform additional procedures to comply with the requirements of AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1).[7]

5.73 AU section 339 includes additional requirements related to the following topics:

- Form, content, and extent of audit documentation
- Significant findings and issues
- Identification of preparer and reviewer
- Documentation of specific items tested
- Documentation of departures from GAAS
- Revisions to audit documentation

Appendix A to AU section 339 lists the audit documentation requirements contained in other areas of AICPA *Professional Standards*.

Audits Conducted in Accordance With PCAOB Standards

5.74 Auditing Standard No. 3, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules*, Standards, AU-P sec. 339), establishes general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to PCAOB standards. *Audit documentation* is the written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise. Audit documentation facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Among other things, audit documentation includes records of the planning and performance of the work, the procedures performed, evidence obtained, and conclusions reached by the auditor.

5.75 The auditor must prepare audit documentation in connection with each engagement conducted pursuant to the standards of the PCAOB. Audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached. Also, the documentation should be appropriately organized to provide a clear link to the significant findings or issues. Examples of audit documentation include memoranda, confirmations, correspondence, schedules, audit plans, and letters of representation. Audit documentation may be in the form of paper, electronic files, or other media.

[7] Guidance related to subsequent events has been incorporated into accounting guidance at Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 855, *Subsequent Events*. See chapter 4, "Financial Statement Presentation and Classification," of this guide for more information.

5.76 Auditing Standard No. 3 (AU-P sec. 339) provides additional guidance on documentation of specific matters, and retention of and subsequent changes to audit documentation. In addition, paragraph 89 of Auditing Standard No. 5 (AU-P sec. 320 par. .89) provides guidance related to the dating of the both the auditor's report on the financial statements and on internal control over financial reporting. It states that the audit report should be dated no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. The guidance further notes that because the auditor cannot audit internal control over financial reporting without also auditing the financial statements, the reports should be dated the same.

Consideration of Fraud in a Financial Statement Audit

5.77 AU section 316 is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in paragraph .02 of AU section 110.

> *Considerations for Audits Prepared in Accordance with PCAOB Standards*
>
> When performing an integrated audit, the auditor should refer to paragraphs 14–15 of Auditing Standard No. 5 (AU-P sec. 320 par. .14–.15) regarding fraud considerations, in addition to the fraud considerations set forth in GAAS.

5.78 Two types of misstatements are relevant to the auditor's consideration of fraud in a financial statement audit:

- Misstatements arising from fraudulent financial reporting
- Misstatements arising from misappropriation of assets

5.79 Three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure,* which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an *opportunity* for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act.

The Importance of Exercising Professional Skepticism

5.80 Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risks of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud[8]

5.81 Members of the audit team should discuss the potential for material misstatement due to fraud in accordance with the requirements of paragraphs .14–.18 of AU section 316. The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the known external and internal factors affecting the entity that might (*a*) create incentives/pressures for management and others to commit fraud, (*b*) provide the opportunity for fraud to be perpetrated, and (*c*) indicate a culture or environment that enables management to rationalize committing fraud. Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit.

5.82 Additional discussion and examples of fraud risk factors for brokers and dealers in securities, classified based on the three conditions generally present when material misstatements due to fraud occur (1) incentives/pressures, (2) opportunities, and (3) attitudes/rationalizations, are included in appendix B to this chapter.

Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

5.83 AU section 314 establishes requirements and provides guidance about how the auditor obtains an understanding of the entity and its environment, including its internal control for the purpose of assessing the risks of material misstatement. In performing that work, information may come to the auditor's attention that should be considered in identifying risks of material misstatement due to fraud. As part of this work, the auditor should perform the following procedures to obtain information that is used (as described in paragraphs .35–.42 of AU section 316) to identify the risks of material misstatement due to fraud:

a. Make inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed. (See paragraphs .20–.27 of AU section 316.)

b. Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit. (See paragraphs .28–.30 of AU section 316.)

c. Consider whether one or more fraud risk factors exist. (See paragraphs .31–.33 of AU section 316, the appendix to AU section 316, and paragraph 5.85 of this guide.)

d. Consider other information that may be helpful in the identification of risks of material misstatement due to fraud. (See paragraph .34 of AU section 316.)

5.84 In planning the audit, the auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or

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[8] The brainstorming session to discuss the entity's susceptibility to material misstatements due to fraud could be held concurrently with the brainstorming session required under AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), to discuss the potential of the risk of material misstatement.

unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting. See appendix B to this chapter for examples of unusual or unexpected relationships that may indicate a material misstatement due to fraud for brokers and dealers in securities.

5.85 *Considering fraud risk factors*. As indicated in paragraph 5.83*c*, the auditor may identify events or conditions that indicate incentives/pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Such events or conditions are referred to as "fraud risk factors." Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

5.86 AU section 316 provides fraud risk factor examples that have been written to apply to most enterprises. See appendix B to this chapter, which contains a list of fraud risk factors specific to brokers and dealers in securities. Remember that fraud risk factors are only one of several sources of information an auditor considers when identifying and assessing risks of material misstatement due to fraud.

Identifying Risks That May Result in a Material Misstatement Due to Fraud[9]

5.87 In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in accordance with the requirements of paragraphs .19–.34 of AU section 316. The auditor's identification of fraud risks may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. In addition, the auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial-statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management. Appendix B [paragraph 5.195] to this chapter provides examples, specific for brokers and dealers in securities, on accounts, classes of transactions and assertions that may have high inherent risk because they involve a high degree of management judgment and subjectivity and are susceptible to manipulation by management.

A Presumption That Improper Revenue Recognition Is a Fraud Risk

5.88 Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition (see paragraph .41

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[9] Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances and disclosures. This requirement provides a link between the auditor's consideration of fraud and assessment of risk, and the auditor's procedures in response to those assessed risks.

of AU section 316). Additional examples of improper revenue recognition for brokers and dealers in securities is included in appendix B to this chapter.

A Consideration of the Risk of Management Override of Controls

5.89 Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk (see paragraph .57 of AU section 316) apart from any conclusions regarding the existence of more specifically identifiable risks. Specifically, the procedures described in paragraphs .58–.67 of AU section 316 should be performed to further address the risk of management override of controls. These procedures include (1) examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, (2) reviewing accounting estimates for biases that could result in material misstatement due to fraud, and (3) evaluating the business rationale for significant unusual transactions.

Key Estimates

5.90 Examples of key estimates for brokers and dealers in securities are provided in appendix B to this chapter.

Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks

5.91 Paragraphs .43–.45 of AU section 316 discuss assessing risks of material misstatement due to fraud that are identified in the evaluation of an entity's programs and controls. Examples of programs and controls for brokers and dealers in securities are provided in appendix B to this chapter.

5.92 The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud or whether specific deficiencies in internal control exacerbate the risks. After the auditor has evaluated whether the entity's programs and controls have been suitably designed and placed in operation, the auditor should assess these risks taking into account that evaluation. This assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud.

Responding to the Results of the Assessment[10]

5.93 Paragraphs .46–.67 of AU section 316 provide requirements and guidance about an auditor's response to the results of the assessment of the risks of material misstatement due to fraud. The auditor responds to risks of material misstatement due to fraud in the following three ways:

a. A response that has an overall effect on how the audit is conducted—that is, a response involving more general

[10] Paragraph .03 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), states that to reduce audit risk to an acceptably low level, the auditor should determine overall responses to address the assessed risks of material misstatement at the financial statement level and should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. See paragraphs .04–.10 of AU section 318. This requirement provides a link between the auditor's consideration of fraud, the assessment of risks, and the procedures in response to those assessed risks.

considerations apart from the specific procedures otherwise planned (see paragraph .50 of AU section 316).

b. A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed (see paragraphs .51–.56 of AU section 316). Examples of auditing procedures that could be performed by auditors of brokers and dealers in securities are provided in the chart titled "Securities Broker-Dealers' Auditing Considerations" at the end of this chapter.

c. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur (see paragraphs .57–.67 of AU section 316 and paragraph 5.89 of this guide).

Evaluating Audit Evidence

5.94 Paragraphs .68–.78 of AU section 316 provide requirements and guidance for evaluating audit evidence. The auditor should evaluate whether analytical procedures that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. The auditor also should consider whether responses to inquiries throughout the audit about analytical relationships have been vague or implausible, or have produced evidence that is inconsistent with other audit evidence accumulated during the audit.

5.95 At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

Responding to Misstatements That May Be the Result of Fraud

5.96 When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. See paragraphs .75–.78 of AU section 316 for requirements and guidance about an auditor's response to misstatements that may be the result of fraud. If the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements, the auditor nevertheless should evaluate the implications, especially those dealing with the organizational position of the person(s) involved.

5.97 If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should

a. attempt to obtain additional audit evidence to determine whether material fraud has occurred or is likely to have occurred, and, if

so, its effect on the financial statements and the auditor's report thereon.[11]

b. consider the implications for other aspects of the audit (see paragraph .76 of AU section 316).

c. discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and those charged with governance.

d. if appropriate, suggest that the client consult with legal counsel.

5.98 The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to those charged with governance. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

Communicating About Possible Fraud to Management, Those Charged With Governance, and Others

5.99 Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is appropriate even if the matter might be considered inconsequential, such as a minor defalcation by an employee at a low level in the entity's organization. See paragraphs .79–.82 of AU section 316[12] for further requirements and guidance about communications with management and those charged with governance.

Documenting the Auditor's Consideration of Fraud

5.100 AU section 316 requires certain items and events to be documented by the auditor related to the auditor's consideration of fraud. Some of the items and events that the auditor should document are as follows:

- Discussion among engagement personnel in planning the audit related to fraud
- Procedures performed to identify risks
- Specific risks identified and the auditor's response to those risks
- Procedures performed in response to the risks identified and the results of those procedures

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[11] See AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), for guidance on auditor's reports issued in connection with audits of financial statements.

[12] PCAOB guidance provided in paragraph .80 of AU-P section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*, Standards), differs from the AICPA guidance in paragraph .80 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1). The phrase "the auditor should consider whether these risks represent *significant deficiencies* or *material weaknesses in the entity's internal control* that *should* be communicated to management and *those charged with governance*" is used in the AICPA *Professional Standards*. The PCAOB equivalent paragraph states "the auditor should consider whether these risks represent *significant deficiencies* that *must* be communicated to *senior management and the audit committee*" in the PCAOB standards.

- Communications about fraud made to management, those charged with governance, and others

See paragraph .83 of AU section 316 for more information.

Consideration of the Work of Internal Auditors

5.101 In audits of broker-dealers, independent auditors may consider using the work of internal auditors. If the independent auditor will be considering or using the work of or receiving direct assistance from the broker-dealer's internal auditors, the provisions of AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1), provide guidance relating to the independent auditor's consideration of internal auditors' competence and objectivity and in evaluating their work.

5.102 AU section 322 also provides guidance concerning the independent auditor's use of work performed by the internal audit function. Reviewing and testing internal control is often an important responsibility of the internal audit function. Thus, the work of the internal auditors may have an important bearing on the independent auditor's procedures. If the independent auditor intends to consider or use the work of or receive direct assistance from the broker-dealer's internal auditors, the independent auditor should follow the guidance in AU section 322 in considering the competence and objectivity of the internal auditor and in evaluating their work.

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
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> When performing an integrated audit, the auditor should refer to paragraphs 16–19 of Auditing Standard No. 5 (AU-P sec. 320 par. .16–.19) for a discussion on using the work of others to alter the nature, timing, and extent of the work that otherwise would have been performed to test controls.

5.103 The broker-dealer's internal auditors or other personnel can also be used to prepare schedules, obtain documentation, and research matters. As objectivity and competence increase, the level of utilization of broker-dealers' personnel may increase as well. For certain internal audit procedures that are objective, competent, and well supervised, independent audit procedures may also consist of reviewing and testing internal audit work.

Analytical Procedures

5.104 Analytical procedures are one of the most effective planning tools used by the auditor to identify potential areas of high risk. AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), requires that analytical procedures be performed during the planning stage and overall review stages of all audits. The statement notes that analytical procedures should be performed in planning the audit, not only to improve the auditor's understanding of the broker-dealer's business and the transactions and events that have occurred since the last audit date, but also to highlight unusual relationships and unexpected fluctuations in the financial information that may require further investigation during the audit. The AICPA Audit Guide *Analytical Procedures* provides practical guidance to auditors on the effective use of analytical procedures. This audit guide includes a discussion of AU section 329; concepts

and definitions; a series of questions and answers; an illustrative case study; and an appendix that includes useful financial ratios.

5.105 Analytical procedures involve the systematic analysis and comparison of recorded amounts or ratios derived from recorded amounts with expectations that have been developed by the auditor. Those expectations may be developed by identifying plausible relationships that are reasonably expected to exist based on understanding the broker-dealer and the industry in which it operates. The goal is to determine any unusual fluctuations, trends, ratios, transactions, events, and amounts that indicate that special attention is merited. Specifically, auditors of broker-dealers may use the following information in performing analytical procedures:

- Internally prepared budgets
- Prior-period financial information
- Forecasts
- Extrapolations from interim data
- Comparisons with industry statistics, broker-dealer financial information, or statistical data prepared by the Securities Industry and Financial Markets Association or other industry groups
- Comparisons of financial information with relevant nonfinancial information

5.106 Analytical procedures can be used when assessing the risks of material misstatement, including accounts or audit areas that require particular attention or those items that need little or no audit emphasis. Analytical procedures are especially useful because of the ease in obtaining information with which to assess a broker-dealer, which thus permits easy identification of areas where greater or lesser effort are necessary. Analytical procedures may be useful as part of the initial planning process to do the following:

- Enhance knowledge of the broker-dealer's business
- Provide a basis for preliminary judgments about materiality
- Increase awareness of inherent risk factors
- Direct attention to accounts and classes of transactions (or changes in them) that merit additional audit emphasis

5.107 Analytical procedures may be useful during the engagement to do the following:

- Corroborate the results of substantive tests of details applied to an account or group of related accounts
- Be used instead of substantive tests of details applied to accounts or portions of accounts where a low level of audit assurance would be desired
- Be used instead of substantive tests of details applied to accounts over which controls operate and have been found to be effective, or to accounts related to other accounts that have been tested through other substantive procedures
- Highlight the need for or assist in the design of specific substantive tests
- Assess the risks of further misstatements in accounts

5.108 At the conclusion of an engagement, analytical procedures may be useful to confirm the results of other audit procedures and help ensure that the auditor is aware of the reasons for all significant fluctuations.

5.109 The auditor may apply analytical procedures to financial statement captions, account balances, and quarterly financial statements, although the extent and timing of the procedures will vary from one broker-dealer to another.

5.110 Specific analytical procedures that may be applicable to a broker-dealer include the following:

- Interest income as a percentage of the average balances of resale transactions, customers' margin receivables, and stock borrows (separately computed), to compare with the average earnings yield on resale transactions, customer margin receivables, and stock borrows, respectively
- Interest expense as a percentage of the average balances of repurchase (repo) transactions, customer payables, and stock loans (separately computed), to compare with the yields incurred on repo transactions, customer payables, and stock loans, respectively
- Mutual fund fees by type compared with transaction volume (such as front-end-load fee income compared with the volume of mutual funds sold to customers or redemption fee income compared with the volume of mutual funds redeemed by customers)
- Management fees compared with the amount of funds under management
- Exchange fees, listed commission income, and expenses as compared with the trading volume on exchanges
- Sales credits on over-the-counter (OTC) trades compared with OTC trading volume
- For nonclearing broker-dealers, the level of interest income or interest expense compared with their money balance at the clearing broker-dealer

5.111 Paragraph .22 of AU section 329 requires that the auditor document certain matters when an analytical procedure is used as the principal substantive test of a significant financial statement assertion.

5.112 For audits conducted in accordance with PCAOB standards, there is additional guidance related to analytical procedures to consider.

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
>
> When performing an integrated audit, paragraph .16 of AU-P section 329, *Analytical Procedures* (AICPA, *PCAOB Standards and Related Rules*, Standards), states that before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information. Furthermore, paragraph .09 of AU-P section 329 indicates that for significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

Auditing Accounting Estimates

5.113 As part of the scope of audit procedures to be performed, it is important to note that certain areas of an audit of broker-dealers' operations require estimates that may be material in the preparation and presentation of the broker-dealer's financial statements. An accounting estimate is an approximation of a financial statement element, item, or account instead of a precise measurement.

5.114 Professional judgment is required in formulating an estimate. Although it is the responsibility of a broker-dealer's management to prepare estimates for the financial statements, the auditor is responsible for evaluating their reasonableness. AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), provides guidance for the auditor on obtaining and evaluating sufficient appropriate audit evidence in support of accounting estimates included in the financial statements.

5.115 Although significant accounting estimates may affect many elements of a broker-dealer's financial statements, they often affect the following:

- Valuation of securities that are not readily marketable or have unobservable inputs, or both, or other investments
- Valuation of derivative contracts, including swaps, options, forwards, futures, and other unsettled transactions and commitments
- Estimates of compensation for deferred 12b-1 fees
- Reserves for promissory notes to employees (contract notes usually forgiven over three to five years)
- Customer reserves
- Estimates of the useful lives of plant, property, and equipment
- Underwriting costs accrued and capitalized based on a high percentage of recovery
- Employee compensation plans, including share-based compensation
- Valuation of exchange memberships
- The estimate of deferred taxes
- Litigation reserves

5.116 The auditor is responsible for evaluating the reasonableness of management's estimates and should consider appropriate procedures in planning and performing the audit. Those procedures should include both subjective and objective factors. In evaluating accounting estimates for reasonableness, the auditor should understand how management developed those estimates. Based on that understanding, the auditor should decide on one or a combination of the following three approaches to assess reasonableness.

a. Review and test the process used by management to develop the estimate. To satisfy this approach, the following procedures may be performed.

   i. Determine what controls (if any) are in operation over the preparation of accounting estimates and the supporting data that may be useful in that evaluation.

ii. Determine whether factors that management used in forming the underlying assumptions are relevant, reliable, and sufficient based on information gathered from other audit tests.

iii. Consider whether the assumptions are consistent with one another, the supporting data, relevant historical data, and industry data.

iv. Consider whether changes in the broker-dealer's business or industry may affect the assumptions underlying the accounting estimates.

v. Test the calculations used by management to convert the assumptions and other factors into the accounting estimates.

b. Develop independent expectations of the estimates used by management for corroboration. Based on the understanding of the facts and circumstances relating to the broker-dealer, the auditor should generate independent expectations that are based on alternative assumptions, as a means of confirming the reasonableness of the accounting estimates.

c. Review subsequent events or transactions occurring prior to the date of the auditor's report. To evaluate the reasonableness of accounting estimates, the auditor may find it helpful to consider events or transactions occurring after the date of the balance sheet but before the completion of fieldwork.

Considerations for Audits Performed in Accordance with PCAOB Standards

When performing an integrated audit, the auditor may use any of the three approaches. However, the work that the auditor performs as part of the audit of internal control over financial reporting should necessarily inform the auditor's decisions about the approach he or she takes to auditing an estimate because, as part of the audit of internal control over financial reporting, the auditor would be required to obtain an understanding of the process management used to develop the estimate and to test controls over all relevant assertions related to the estimate. (Note to paragraph .10 of AU-P section 342, *Auditing Accounting Estimates* [AICPA, *PCAOB Standards and Related Rules*, Standards].)

5.117 As investment strategies increasingly include investing in more complex and higher risk securities, the values of securities may not be readily available through market quotations. Such securities are often valued at amounts determined by the broker-dealers' management in accordance with Financial Accounting Standards Board *Accounting Standards Codification* 820, *Fair Value Measurements and Disclosures*. Auditing the valuation of such securities is an area that requires a high degree of judgment and scrutiny to ensure that the valuation procedures are reasonable and underlying support is appropriate. There is no single method for determining fair value in good faith because fair value depends on the facts and circumstances of each individual case. In auditing securities valuations determined by management,

auditors should review the information that formed the basis for the valuations and ascertain that the procedures followed were reasonable. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), provides guidance on auditing fair value measurements and disclosures contained in financial statements. Under AU section 328, the auditor's substantive tests of fair value measurements involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data, (*b*) developing independent fair value estimates for corroborative purposes, or (*c*) examining subsequent events and transactions that confirm or disconfirm the estimate. In some instances, the auditor may consider using the work of a specialist in auditing the valuation of such securities. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance when auditors consider the work done by a specialist. AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1), among other matters, provides guidance to auditors in planning and performing auditing procedures for assertions about investments in securities that are made in an entity's financial statements. A companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* provides practical guidance for implementing AU section 332.

Audits Conducted in Accordance With GAAS

5.118 Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist," of AU section 332 (AICPA, *Professional Standards*, vol. 1, AU sec. 9332 par. .01–.04), provides guidance for audits conducted in accordance with GAAS pertaining to situations where a readily determinable fair value does not exist. For example, an entity may have an investment in a hedge fund that it reports at fair value, but for which a readily determinable fair value does not exist. Further, the hedge fund may own interests in investments in limited partnership interests or other private equity securities for which a readily determinable fair value does not exist. As part of an auditor's procedures in accordance with AU section 332, the auditor typically would satisfy the existence assertion through either confirmation with the hedge fund, examination of legal documents, or other means as discussed in AU section 332. In confirming the existence, the auditor may request the hedge fund to indicate or to confirm the fair value of the entity's investment in the hedge fund, including the fair value of investments held by the hedge fund. In some circumstances, the hedge fund will not provide management or the auditor detailed information about the basis and method for measuring the entity's investment in the hedge fund, nor will they provide information about the specific investments held by the hedge fund. For example, in some circumstances the hedge fund may inform management or the auditor that investments are held by the hedge fund as follows:

- In aggregate, such as "$XXX of total investments"
- In aggregate, such as "$XXX of total investments in private equity securities, $YYY of total investments in interests in limited partnerships, and $ZZZ of total investments in debt securities"
- On an investment-by-investment basis, such as "AA shares of common stock of private company A, with a fair value of $AAA; BB shares of preferred stock of private company B, with a fair value

of $BBB; CC units of limited partnership interest CCC, with a fair value of $CCC; and real estate property DDD, with a fair value of $DDDD"

In circumstances in which the auditor determines that the nature and extent of auditing procedures should include verifying the existence and testing the measurement of investments in securities, simply receiving a confirmation from a third party, either in aggregate or on a security-by-security basis, does not in and of itself constitute adequate audit evidence with respect to the valuation assertion in AU section 332. In addition, receiving confirmation from a third party for investments in aggregate (illustrated by the first two bullets) does not constitute adequate audit evidence with respect to the existence assertion under AU section 332. Receiving confirmation from a third party on a security-by-security basis (illustrated by the third bullet), however, typically would constitute adequate audit evidence with respect to the existence assertion under AU section 332.

Going-Concern Considerations

5.119 AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), provides guidance to the auditor with respect to evaluating whether there is substantial doubt about the broker-dealer's ability to continue as a going concern.

5.120 Continuation of a broker-dealer as a going concern is assumed in financial reporting in the absence of significant information to the contrary. Ordinarily, information that significantly contradicts the going-concern assumption relates to the broker-dealer's inability to continue to meet its obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt, noncompliance with various rules and regulations, externally forced revision of its operations, or similar actions. The ability of a broker-dealer to meet statutory net capital requirements is a major factor to consider in assessing the going-concern assumption.

5.121 During the course of the audit, the auditor may become aware of information that raises substantial doubt about the broker-dealer's ability to continue as a going concern. AU section 341 states that the auditor has a responsibility to evaluate whether there is substantial doubt about the broker-dealer's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. The evidence necessary to make this evaluation will usually be obtained through planning and gathering audit evidence relative to the various audit objectives (including review of compliance with debt agreements, analytical procedures, and subsequent events) and through completing the audit. If, after considering the identified conditions and events in the aggregate, the auditor believes that there is substantial doubt about the ability of a broker-dealer to continue as a going concern, he or she should consider management's plans to mitigate the current conditions and events, the effect on the financial statements and the related disclosures, and the effects on the auditor's report. Paragraph .17 of AU section 341 requires the auditor to document certain matters if, after considering the identified conditions and events in the aggregate, the auditor believes there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.

Communication of Matters Related to Internal Control

Audits Conducted in Accordance With GAAS

5.122 AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements. In particular, AU section 325

- defines the terms *deficiency in internal control, significant deficiency*, and *material weakness*.
- provides guidance on evaluating the severity of deficiencies in internal control identified in an audit of financial statements.
- requires the auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses identified in an audit.

5.123 Deficiencies identified during the audit that upon evaluation are considered significant deficiencies or material weaknesses should be communicated in writing to management and those charged with governance as a part of each audit, including significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits, and have not yet been remediated. A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A *significant deficiency* is a deficiency, or combination of deficiencies, in internal control, that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

5.124 The written communication is best made by the *report release date*, which is the date the auditor grants the entity permission to use the auditor's report in connection with the financial statements, but should be made no later than 60 days following the report release date. Nothing precludes the auditor from communicating to management and those charged with governance other matters related to an entity's internal control that the auditor believes may be of potential benefit to the entity. This includes deficiencies identified that are not considered to be significant deficiencies or material weaknesses. Paragraph .22 of AU section 325 provides guidance on what should be included in communication. The auditor should not issue a written communication stating that no significant deficiencies were identified; however, the communication may state that no deficiencies were identified that are considered to be material weaknesses. If an entity is required to furnish such auditor communications to a governmental authority, specific reference to such governmental authorities may be made.

Audits Conducted in Accordance With PCAOB Standards

5.125 AU-P section 325, *Communications About Control Deficiencies in an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Standards), as revised by Auditing Standard No. 5 (AU-P sec. 320), provides

guidance on identifying and reporting deficiencies in the company's internal control over financial reporting in an audit of financial statements in accordance with PCAOB standards. It provides that the auditor must communicate in writing to management and the audit committee all significant deficiencies and material weaknesses identified during the audit. PCAOB standards define significant deficiency and material weakness slightly different than does GAAS.[||] PCAOB defines a significant deficiency as a deficiency, or combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis. The written communication required by paragraph .04 of AU-P section 325 should be made prior to the issuance of the auditor's report on the financial statements. The auditor's communication should distinguish clearly between those matters considered significant deficiencies and those considered material weaknesses.

5.126 If oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, that circumstance should be regarded as at least a significant deficiency and as a strong indicator that a material weakness in internal control over financial reporting exists which the auditor must communicate in writing to the board of directors.

5.127 The auditor might identify matters in addition to those required to be communicated by AU-P section 325. Such matters include control deficiencies identified by the auditor that are neither significant deficiencies nor material weaknesses and matters the company may request the auditor to be alert to that go beyond those contemplated by this standard. The auditor may report such matters to management, the audit committee, or others, as appropriate.

5.128 The auditor should not report in writing that no significant deficiencies were discovered during an audit of financial statements because of the potential that the limited degree of assurance associated with such a report will be misunderstood.

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
>
> When performing an integrated audit, the auditor should refer to paragraphs 78–84 of Auditing Standard No. 5 (AU-P sec. 320 par. .78–.84) for guidance on required communications.

Communication With Those Charged With Governance

5.129 AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1), has been updated for the issuance of SAS No. 114. The auditor must communicate with those charged

[||] Upon the effective date of SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), the GAAS definitions for *material weakness* and *significant deficiency* conform to those in Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Standards, AU-P sec. 320).

with governance matters related to the financial statement audit that are, in the auditor's professional judgment, significant and relevant to the responsibilities of those charged with governance in overseeing the financial reporting process. The new guidance defines "those charged with governance" as the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the reporting process. (In some cases, those charged with governance are responsible for approving the entity's financial statements, whereas in other cases management has this responsibility.) AU section 380 is applicable to all broker-dealers being audited under GAAS, regardless of their governance structure or size. AU section 380 establishes a requirement for the auditor to communicate certain matters relating to the audit. This includes

- the auditor's responsibilities under GAAS,
- an overview of the planned scope and timing of the audit, and
- significant findings from the audit.

Although the communication can be oral, it should be in writing when, in the auditor's judgment, oral communication would not be adequate. In the event the required communication is oral, it should be documented by the auditor. AU section 380 also contains information on the communication process, timing of communication and specific examples of what should be communicated. (See paragraphs .23–.44 of AU section 380 for examples of items to be communicated.) Paragraph .40 of AU section 380 states that the auditor should communicate uncorrected misstatements and the effect that they may have on the opinion in the auditor's report, and may request their correction. Paragraphs .40–.41 of AU section 380 contains more information related to the communication of misstatements. AU section 380 also states that open and constructive communication about qualitative aspects of the entity's significant accounting practices may include comment of the acceptability of significant accounting practices. Appendix B of AU section 380 provides guidance on the matters that may be included in this communication. AU section 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1), refers to reports issued under AU section 380 as by-product reports, and states that the use of such reports should be restricted.

Management Representations

5.130 AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), establishes a requirement that an auditor, performing an audit in accordance with GAAS, obtain written representations from management for all financial statements and periods covered by the auditor's report. AU section 333 also provides guidance concerning the representations to be obtained, along with an illustrative management representation letter. The management representation letter should include an acknowledgement by management that the effects of any uncorrected financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of the uncorrected misstatements should be included in or attached to the representation letter. Certain other representations related to a broker-dealer's operations are normally obtained (see appendix H, "Representation Letter," of this guide).

Considerations for Audits Perfomed in Accordance with PCAOB Standards

When performing an integrated audit, the auditor should refer to paragraphs 75–77 of Auditing Standard No. 5 (AU-P sec. 320 par. .75–.77) for additional required written representations to be obtained from management.

5.131 In August 2002, the SEC adopted final rules for "Certification of Disclosure in Companies' Quarterly and Annual Reports." In response to Section 302(a) of the Sarbanes-Oxley Act of 2002, CEOs and CFOs, or persons performing similar functions, are now required to certify the financial and other information contained in quarterly and annual reports and make certain disclosures. This certification includes (among other things) (*a*) the accuracy of the filed report, (*b*) the design of the issuer's internal accounting controls, and (*c*) the disclosure to the audit committee of any material weaknesses in those controls.

5.132 As part of the certification of financial statements required by the Sarbanes-Oxley Act of 2002, the CEO and the CFO of a publicly held broker-dealer are required to disclose to the broker-dealer's audit committee and independent auditors all significant deficiencies in the design or operation of internal controls which could adversely affect the broker-dealer's ability to record, process, summarize and report financial data, and to identify to the auditors any material weaknesses in internal controls. Further, they are to disclose to the audit committee and the auditors any fraud, whether or not material, that involves management or other employees who have a significant role in the broker-dealer's internal controls.

5.133 AU section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1), requires the auditor to obtain audit evidence relevant to litigation, claims, and assessments. AU section 337 concludes that a letter of inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments. The auditor should obtain a client representation about the following factors:

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

Effect of Information Technology on Internal Control

5.134 Consideration of the type and complexity of methods the broker-dealer uses to process accounting information may influence the nature, timing, and extent of the audit procedures to be performed. The use of computers is often an important element of a broker-dealer's processing and control environment, regardless of the size of the business. The large volume of transactions and the need to maintain accountability for security positions (both ownership and location) are among the reasons most broker-dealers have automated their record keeping systems.

5.135 AU section 314 states that in obtaining an understanding of internal control sufficient to plan the audit of financial statements, the auditor should obtain an understanding of how an entity's use of IT and manual procedures may affect controls relevant to the audit. IT encompasses automated means of originating, processing, storing, and communicating information, and includes recording devices, communication systems, computer systems, and other electronic devices. The auditor is primarily interested in the entity's use of IT to initiate, authorize, record, process, and report transactions or other financial data. An entity's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives, and its operating units or business functions. The use of IT also affects the fundamental manner in which transactions are initiated, authorized, recorded, processed, and reported.

5.136 IT provides potential benefits of effectiveness and efficiency for an entity's internal control, and also poses specific risks to an entity's internal control. The extent and nature of the specific risks to internal control vary depending on the nature and characteristics of the entity's information system.

5.137 The auditor, when assessing the risks of material misstatement in terms of financial statement assertions, should consider, among other things, the nature and complexity of the systems, including the use of IT, by which the entity processes and controls information supporting the assertion. In circumstances where a significant amount of information supporting one or more financial statement assertions is electronically initiated, authorized, recorded, processed, or reported, the auditor may determine that it is not possible to design effective substantive tests that by themselves would provide sufficient evidence that the assertions are not materially misstated. For such assertions, significant audit evidence may be available only in electronic form. In such cases, its competence and sufficiency as audit evidence usually depend on the effectiveness of controls over its accuracy and completeness. Furthermore, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, authorized, recorded, processed, or reported only in electronic form and appropriate controls are not operating effectively. In such circumstances, the auditor should perform tests of controls to gather audit evidence to use in assessing the risks of material misstatement.

5.138 The auditor should consider whether specialized skills are needed for the auditor to determine the effect of IT on the audit, to understand the IT controls, or to design and perform tests of IT controls or substantive tests. A professional possessing IT skills may be either on the auditor's staff or an outside professional. The auditor should also consider whether specialized skills are needed to design or perform tests of automated controls.

Consideration of Controls at IT Service Centers

5.139 A broker-dealer may use outside service organizations (sometimes referred to as "service centers") to perform services that are part of the broker-dealer's information system. A service organization's services are part of an entity's information system if they affect any of the following:

- The classes of transactions in the entity's operations that are significant to the entity's financial statements

- The procedures, both automated and manual, by which the entity's transactions are initiated, authorized, recorded, processed, and reported from their occurrence to their inclusion in the financial statements
- The related accounting records, whether electronic or manual, supporting information, and specific accounts in the entity's financial statements involved in initiating, authorizing, recording, processing and reporting the entity's transactions
- How the entity's information system captures other events and conditions that are significant to the financial statements
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures

The use of a service organization may improve internal control because of the separation of responsibilities inherent in the third-party status of the service organization. Accordingly, transactions that affect its financial statements flow through accounting systems that are—at least in part—physically and operationally separate from the broker-dealer.

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
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> When performing an integrated audit, the auditor should refer to paragraphs B17–B27 of appendix B, "Special Topics," of Auditing Standard No. 5 (AU-P sec. 320) regarding the use of service organizations.

5.140 AU section 314 states that the auditor should obtain an understanding of an entity's internal control, sufficient to assess the risks of material misstatement and design the nature, timing, and extent of further audit procedures. This understanding may encompass controls placed in operation by the broker-dealer and by service organizations whose services are part of the broker-dealer's information system.

5.141 AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1),[#] explains the considerations an auditor should make in obtaining an understanding of internal control and assessing control risk for entities that use a service organization to process transactions. See paragraphs 5.134–.138 for a discussion of the auditor's consideration of an entity's use of IT.

5.142 The auditor should identify significant classes of transactions that are processed by the service center and understand the flow of transactions through the entire accounting system, including the portion maintained by the service center. The facts and circumstances of each case will impact the determination of the additional work that needs to be done by the auditor with regard to controls at the service center. If, for example, after examining the output of the service center, the auditor is satisfied that the broker-dealer can check the daily output throughout the year, he or she may not need to consider

[#] In April 2010, the Auditing Standards Board issued Statement on Standards for Attestation Engagements No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, vol. 1, AT sec. 801). AT section 801 addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user entities when those controls are likely to be relevant to user entities' internal control over financial reporting. It is effective for service auditors' reports for periods ending on or after June 15, 2011. Early implementation is permitted. This standard supersedes the guidance for service auditors in AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1).

the service center's processing controls any further. However, the auditor should inquire about problems pertaining to system continuity or data file security that are due to inadequate equipment or program backup or to poor control at the service center.

5.143 Information about the nature of the services provided by the service organization that are part of the broker-dealer's information system and the service organization's controls over those services may be available from sources such as user manuals, system overviews, technical manuals, the contract between the broker-dealer and the service organization, and reports by auditors of the service organization (service auditors), internal auditors, or regulatory authorities on the service organization's controls. If the services and the service organization's controls over those services are highly standardized, information obtained through the broker-dealer auditor's prior experience with the service organization may be helpful in planning the audit.

5.144 After considering the available information, the auditor of the broker-dealer may conclude that he or she has the means to obtain a sufficient understanding of internal control to assess the risks of material misstatement. If the auditor of the broker-dealer concludes that information is not available to obtain a sufficient understanding to assess the risks of material misstatement, he or she may consider contacting the service organization, through the broker-dealer, to obtain specific information or request that a service auditor be engaged to perform procedures that will supply the necessary information, or the auditor of the broker-dealer may visit the service organization and perform such procedures. If the auditor of the broker-dealer is unable to obtain sufficient evidence to achieve his or her audit objectives, the auditor of the broker-dealer should qualify his or her opinion or disclaim an opinion on the financial statements because of a scope limitation.

5.145 In considering whether the service auditor's report is satisfactory for his or her purposes, the broker-dealer's auditor should make inquiries concerning the service auditor's professional reputation. See AU section 324 for further guidance.

5.146 If the auditor believes that the service auditor's report may not be sufficient to meet his or her objectives, the auditor may supplement his or her understanding of the service auditor's procedures and conclusions by discussing with the service auditor the scope and results of the service auditor's work. In addition, if the auditor believes it is necessary, he or she may contact the service organization, through the broker-dealer, to request that the service auditor perform agreed-upon procedures at the service organization, or the auditor may perform such procedures.

Omnibus and Fully Disclosed Accounts

5.147 The following paragraphs provide a discussion of certain unique auditing procedures to consider when testing omnibus and fully-disclosed accounts.

Omnibus Accounts

5.148 *Carrying or clearing broker.* A broker-dealer may perform clearing functions for other brokers (the initiating or introducing brokers). Such transactions are recorded in accounts designated as omnibus or fully disclosed accounts.

Confirmation of material balances in omnibus accounts generally provides the auditor with the most reliable evidence of the balance. An explanation from the broker-dealer of any differences that exist between the books and confirmation responses, and tracing any reconciling items to supporting documentation will assist the auditor in verifying the correct balance. Testing of the clearing broker's segregation, transfer, and cashiering operations and of the controls pertaining to transactions of the initiating broker will assist the auditor in determining that the instructions of the initiating broker were carried out on a timely basis, in compliance with their agreement, and in accordance with the prescribed rules and regulations of applicable regulatory agencies. In addition, the auditor may want to trace selected trades in the omnibus accounts to underlying documentation furnished by the initiating broker and test that the clearing fee is in conformity with the applicable agreement.

5.149 *Introducing broker.* Confirmation of the balance in the omnibus account by the clearing broker will assist the auditor in verifying that the balance is valid and complete. Tracing any difference between the confirmation response and the client's records to underlying documentation will assist in verifying the reconciling items. The auditor may consider testing the computation of the clearing fee for compliance with the related agreement in addition to considering the introducing broker-dealer's obligations pursuant to the clearing agreement as to guaranteeing the deficits of its introduced customers.

Fully Disclosed Accounts

5.150 *Carrying or clearing broker.* Because the accounts of the introducing broker's customers are maintained on the books of the carrying broker, as if they were customers of the carrying broker, the auditing procedures for those accounts are the same as those performed on other customers' accounts. In addition, the auditor may consider testing the fees earned for carrying the other broker's accounts.

5.151 *Introducing broker.* Tests to determine that the introducing broker is credited with the agreed-on fee for trades generated by its customers, testing of the introducing broker's system to verify that all trades were executed in accordance with its instructions and that the fees comply with the applicable agreement provides the auditor with audit evidence regarding customer transactions. Such tests would ordinarily include comparing daily trading activity summaries prepared by the carrying broker with memorandums of the introducing broker. In addition, the auditor may consider testing the computation of the clearing fee for compliance with the related agreement in addition to the introducing broker-dealer's obligations pursuant to the clearing agreement as to guaranteeing the deficits of its introduced customers.

5.152 When auditing the omnibus account of an introducing broker or the fully disclosed accounts of an introducing broker, the auditor typically considers both the relationship with and the financial viability of the clearing or carrying broker, respectively, and may consider whether, under the guidelines of AU section 324 it would be best to request a service auditor's report from the clearing or carrying broker.

Substantive Audit Procedures

5.153 Certain auditing procedures unique to an audit of a broker-dealer are discussed in the following paragraphs. The chart beginning at the end of

this chapter provides illustrations of audit assertions, audit objectives, and substantive tests. In accordance with paragraph .07 of AU section 318, the nature, timing and extent of these procedures should be based on the auditor's assessment of the risks of material misstatements at the assertion level. In addition, there are other auditing procedures that need to be performed in the audits of broker-dealers that are not unique to such audits or that do not require special application in them. Such procedures are not discussed in this chapter and auditors can refer to other sources for those requirements.

Stock Record

5.154 The specific audit objective related to the stock record is to determine that positions are in balance (meaning that total long positions equal total short positions). Verifying that a balanced stock record exists is similar to verifying that the trial balance balances. It provides evidence of completeness and acts as a reference tool for audit procedures applied to accounts with securities positions and as additional assurance that general ledger account balances are accurate.

5.155 The auditor generally tests the stock record to ensure that positions are in balance and to test the balancing of selected items. Audit evidence for stock record positions may be obtained by physical inspection, through confirmation, or by a combination of both.

Securities in Physical Possession

5.156 The auditor would normally account for securities in physical possession by counting them or by observing and testing the broker-dealer's procedures for physical inspection as part of the quarterly security count requirements of SEC Rule 17a-13.

5.157 If the auditor observes the broker-dealer's security count, items to consider are the following:

- Evaluate whether procedures employed result in a complete and accurate count.
- Review the procedures used and the execution of those procedures.
- Perform test counts, to the extent necessary, and follow-up procedures to clear exceptions.

5.158 If the securities on hand are tested at interim dates, the auditor may want to be involved in the quarterly count made on the date closest to the date of the financial statements. This involvement could be limited to discussions with the broker-dealer and to a review of the procedures to be followed during the count to determine whether they are consistent with those that the auditor has previously reviewed, tested, and determined to be reasonable.

5.159 Depending on the significance of the security count (considering the volume of securities on hand or the involvement of internal auditors), the auditor may want to be present during portions of the count to be satisfied that those procedures are being followed and that there has been no change from the procedures tested. See also the guidance provided in AU section 322 and AU section 318, as it may be relevant to the audit of a broker-dealer.

5.160 The auditor typically inquires about the results of the count and determines whether there are any material unresolved differences. If there are such differences, testing may be performed so that the auditor is satisfied,

to the extent he or she considers necessary, concerning the reason, nature, and ultimate disposition of the differences and their effect on the financial statements and other regulatory reporting requirements.

Securities in for Transfer, Exchange, or Redemption

5.161 A broker-dealer, particularly one that engages in a substantial volume of transactions, may have a separate transfer department or division to handle securities held for transfer.

5.162 Securities out for transfer may be audited, to the extent the auditor deems necessary, by direct correspondence with the transfer agents or the corporate issuers or by physical inspection of the securities when they are returned to the broker-dealer. In determining the procedures to be applied, consideration may be given to the extent to which transfers are being processed through a depository or, if they are being processed by a transfer agent, the length of time that such items have been in transfer. An audit of the securities when they are returned implies that it is reasonable to assume that such returns suggest that the securities were held by the transfer agent on the date being tested.

Securities Serviced at Depositories

5.163 The auditor might consider confirming directly with depositories and clearing organizations security positions serviced on behalf of the broker-dealer as of the date of the security count. A reconciliation, prepared by the broker-dealer of positions serviced by these organizations can be tested by comparing it to the statement received directly from the organizations.

5.164 For the continuous net settlement accounts, there is a direct relationship between the net market value of the securities to be settled and the money to be settled. Testing can be performed through a review of this relationship, in addition to explanations being provided by the broker-dealer for any differences noted during testing. Because most of the securities serviced by broker-dealers will be located at depositories, the auditor needs to consider internal control in effect at such organizations. The auditor may do so by obtaining the most recent report issued by that organization's independent auditors on the organization's internal control (see AU section 324).

Securities Failed to Receive and Failed to Deliver, Securities Borrowed and Loaned, Securities Held Under Repos and Reverse Repos, and Securities Held as Collateral for Bank Loans

5.165 The auditor would normally test the positions of securities failed to receive, failed to deliver, borrowed and loaned, held under repos and reverse repos, and held as bank loan collateral through confirmation with the other party to the transaction. The following factors affect the extent of the confirmation procedures to perform

- the auditor's judgment concerning internal control,
- the size of the accounts, and
- the types of error or fraud that have occurred in the past.

Securities Held by Branch Office

5.166 The auditor typically inquires about securities held by branch offices and, if they are material, considers whether to inspect them in coordination with

the inspection at the main office. Upon consideration of this information, the auditor can determine whether a review of the broker-dealer's procedures for controlling and accounting for securities at branch offices would be sufficient.

> *Considerations for Audits Performed in Accordance with PCAOB Standards*
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> When performing an integrated audit, the auditor should refer to paragraphs B10–B16 of appendix B of Auditing Standard No. 5 (AU-P sec. 320) for considerations when a company has multiple locations or business units.

Securities Position Differences

5.167 All differences disclosed through the comparison of counts and confirmations with the records of the broker-dealer normally are examined and resolved by the broker-dealer, with adjustments being reviewed by the auditor to the extent considered necessary.

Customers' Accounts (Including Partners, Officers, Directors, Employees, and Shareholders)

5.168 The auditor normally confirms account positions and balances. Sampling techniques may be suitable if there are many accounts. In selecting customers' accounts for confirmation, the auditor needs to consider the value of the security positions in such accounts, as well as the ledger (money) balances; the auditor also typically considers confirming some accounts with zero balances. AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), provides guidance[13] to the auditor on using confirmations.

5.169 The broker-dealer might, for its own purposes, request that the auditor extend the confirmation of customers' accounts beyond those necessary for purposes of the audit. In those cases, the auditor can consider the implications on his or her auditing procedures of misstatements discovered in performing the additional confirmations at the request of the client.

5.170 The auditor can also review customers' accounts for evidence of undermargined, partly secured, or unsecured conditions that may affect the net capital computation under SEC Rule 15c3-1 and the reserve and possession-or-control requirements of Rule 15c3-3, as well as the collectibility of accounts. In performing such a review, it may be helpful to obtain an equity run, which is a report that indicates, for each customer's account, the ledger balance and the market values of all securities positions in the account. In performing audit procedures in the customer area, review of the broker-dealer's practices and procedures that are established to comply with Regulation T and SEC Rules 15c3-1 and 15c3-3 is normally included.

Trading and Investment Accounts[14]

5.171 The auditor will likely want to ascertain that the trading department position records are in agreement with or have been reconciled to the stock

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[13] See Interpretation No. 1, "Use of Electronic Confirmations," of AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 9330 par. .01–.08), regarding the use of electronic confirmations.

[14] See discussion of FASB ASC 820, *Fair Value Measurements and Disclosures*, in chapter 7, "Accounting Standards."

record and that accruals on the broker-dealer's inventory positions related to unsettled trades and related profit or loss are recorded. For further details, see section titled "Trade-Date Versus Settlement-Date Accounting" in chapter 7, "Accounting Standards," in this guide. In addition, the auditor usually tests the values of such securities with all pricing sources being indicated in the audit documentation.

5.172 For securities with no ready market, the auditor does not function as an appraiser and is not expected to substitute his or her judgment for that of the management of the broker-dealer in determining value; rather, the auditor typically reviews the information relied on by management to determine whether the procedures followed are reasonable in the circumstances.

5.173 The auditor performs those test calculations that he or she deems necessary in the circumstances. As partial substantiation for the valuation of such securities, the auditor may also wish to review purchases or sales made shortly before and after the valuation date being tested. The auditor may also request a valuation from other broker-dealers or consider the use of an independent valuation service.

5.174 Management's valuation procedures of securities that are not readily marketable are designed to approximate the fair value. Those procedures are generally a good-faith estimate by management. If the auditor concludes that the procedures used to estimate value are reasonable and the documentation is appropriate, the opinion need not be modified. However, if the auditor concludes otherwise, a modified opinion may be appropriate.

5.175 AU section 328 provides guidance on auditing fair value measurements and disclosures contained in financial statements. Under AU section 328, the auditor's substantive tests of fair value measurements involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data, (*b*) developing independent fair value estimates for corroborative purposes, or (*c*) examining subsequent events and transactions that confirm or disconfirm the estimate. AU section 332 among other matters, provides guidance to auditors in planning and performing auditing procedures for assertions about investments in securities that are made in an entity's financial statements. The companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides practical guidance for implementing AU section 332. For audits conducted in accordance with GAAS, Interpretation No. 1, "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value," of AU section 328 (AICPA, *Professional Standards*, vol. 1, AU sec. 9328 par. .01–.04), and Interpretation No. 1 of AU section 332 provide that if the auditor determines that the nature and extent of auditing procedures should include tests of the measurement of investments in securities (or interests in a trust that holds investments in securities), simply receiving a confirmation from a third party (including a trustee) does not, in and of itself, constitute adequate audit evidence with respect to the valuation assertion. The interpretations also provide that receiving confirmation from a third party (including a trustee) for investments in aggregate does not constitute adequate audit evidence with respect to the existence assertion. Receiving confirmation from a third party (including a trustee) on a security-by-security or investment-by-investment basis, however, typically would constitute adequate audit evidence with respect to the existence assertion.

Good-Faith Deposits

5.176 Normally, good-faith deposits accompany bids to purchase new issues of securities. The deposit and the related commitment can normally be confirmed at the same time. The broker-dealer may be acting as the manager of a group making a bid for a new issue of securities; in such cases, the other participating members usually deposit proportionate amounts of the required deposit with the managing dealer. The auditor may request that the participants confirm in writing the amount of their deposits.

Subordinated Accounts and Borrowings

5.177 The auditor performs tests so that he or she obtains information concerning cash subordination or secured demand note agreements and also determines whether they have been approved by the appropriate regulatory bodies. That may be done through direct confirmation. The auditor can also determine, through confirmation, the expiration dates of the agreements, the amounts subordinated, any collateral, any limits in relation to those amounts, and the nature of the liability to the subordinating party. In addition, the auditor usually examines whether the broker-dealer is in compliance with any restrictive covenants contained in the subordination agreement. This information is needed to determine the proper carrying value of the accounts and the appropriate treatment under net capital rules.

Dividends Receivable or Payable

5.178 Dividends receivable in cash or securities can be analyzed by the auditor and reviewed for age and collectibility, and those that are material in amount may be confirmed, as deemed necessary. The auditor may review the procedures for recording dividends receivable and payable to determine the extent of material unrecorded amounts.

Unclaimed Dividends, Coupons, and Securities

5.179 The auditor generally reviews the procedures followed by the broker-dealer for recording material transactions in accounts for unclaimed dividends, coupons, and securities. Detailed accounts maintained for unclaimed items can be compared with control accounts. Charges against unclaimed items can be examined on a selected basis and compared with claims or correspondence, particularly charges against older items. The auditor can perform a review of the broker-dealer's procedures for determining its compliance with state escheat laws. Market action affecting underlying items may give rise to contingent liabilities and net capital charges, and such activity is typically reviewed.

Exchange Memberships

5.180 The ownership of exchange memberships can be confirmed through direct correspondence with the exchange. It is not unusual for a broker-dealer to have more than one membership on a particular exchange. The propriety of considering exchange memberships as assets of the broker-dealer is typically ascertained by referring to partnership agreements or other documents of the broker-dealer. The propriety of the carrying value of the memberships and whether the carrying value has been impaired are factors and may need to be tested. Due to the demutualization of some exchanges, membership may not be aligned with ownership in the exchange. In a demutualization, trading privileges are disaggregated from ownership and valuation of memberships and

other forms of ownership/trading privileges need to be carefully evaluated by the auditor.

Open Contractual Commitments

5.181 The auditor may wish to confirm contractual commitments (other than endorsed puts and calls, the holders of which are unknown) on a test basis. In many cases, the commitments of customers will appear in their accounts and will be confirmed when those accounts are confirmed. In other cases, information concerning purchases and sales of securities on a when-issued or when-distributed basis may not appear in the customers' accounts or in the stock record, but may be maintained instead in a subsidiary record (such as tickets in an open contract file). In such cases, the open contracts may be confirmed in the same manner as are other accounts.

5.182 Sometimes, if a settlement date (subsequent to the date of the financial statements) has been fixed for an open contract transaction, the broker-dealer will clear the open contract file and enter the transactions on the settlement blotter for the day of settlement. Such transactions are not regular-way transactions and may be confirmed separately.

5.183 Another type of contract involves the broker-dealer's interest in joint accounts in issued or to-be-issued securities carried by other broker-dealers. In many cases, the interest in those security positions contained within the accounts is not recorded in the general ledger of the noncarrying member of the joint account. In such cases, an adjustment is usually recorded in the trial balance to reflect such accounts in the financial statements. Details of the joint accounts may be confirmed in writing with the carrying broker-dealers to the extent the auditor considers necessary.

5.184 Broker-dealers that engage in underwriting securities for issuers may incur an open contractual commitment in the event the firm definitively and conclusively agrees or contracts to underwrite an issuer's securities prior to its offering. Typically, this type of commitment occurs immediately prior to the offering. However, broker-dealers may enter into a contract with an issuer that provides a "firm commitment" to underwrite securities several days or weeks prior to the actual offering. The auditor may wish to look at a broker-dealer's underwriting function to ensure the identification and proper recording, including regulatory capital charges, of any underwriting open contractual commitments.

Private Placements

5.185 The audit of private placement transactions may include a review with management of agreements between the broker-dealer and entities for which debt or equity securities have been placed. The auditor typically reviews the status of the individual contracts to determine any existing broker-dealer obligations that may require disclosure in the financial statements. In addition, the auditor may want to consider confirming outstanding contractual agreements offsetting customers' commitments to purchase such securities.

Mutual Funds

5.186 Procedures for testing mutual fund transactions will differ depending on the amount of activity and the method of accounting for customer purchases and redemptions. Few auditing procedures are necessary in cases in which the broker assists a customer in the purchase or redemption of mutual

fund shares in the name of the customer. However, if a broker-dealer, acting in a custodial capacity for customers, maintains an active account in its name with one or more mutual funds, certain procedures may be considered, including confirming the number of shares held by the mutual funds in the name of the broker-dealer and comparing those quantities to safekeeping records of the broker-dealer. The auditor may consider testing the accrual of 12b-1 fees, as well as the methodology used in deferring and amortizing deferred sales charges, by reviewing the broker-dealer's control over customer-owned mutual fund shares that it has sold. Depending on the materiality of open purchases or redemptions, those amounts may also be confirmed.

Municipal Refunding Bond Underwritings

5.187 The auditor's objectives in examining municipal refunding bond underwritings generally are similar to those for regular underwritings and open contractual commitments. However, the auditor usually also performs tests to determine whether the broker-dealer has met its commitment to the issuer to purchase U.S. government securities that are to be placed in escrow. Often, U.S. government securities may not be available in the quantities desired or at the same price as anticipated at the time the underwriting agreement was executed. In such cases, the broker-dealer may sustain losses in satisfying its obligation to the issuer. These losses are recorded in the accounts.

Suspense Accounts

5.188 The purchase and sales and the operations suspense accounts are typically analyzed by the broker-dealer at the end of the period and these amounts are then charged to income or expense or reclassified as appropriate to accounts such as inventory, customer, receivable, or payable or to other accounts for financial reporting purposes. The auditor reviews the analysis for propriety of aging and classification, and might also test specific items by confirmation with third parties, comparison with underlying records, or other procedures.

Computation of Formula for Determination of Reserve Requirement, Possession or Control of Securities, and Net Capital

Reserve Requirement and Possession or Control of Securities

5.189 SEC Rule 15c3-3 requires every broker-dealer who carries customer accounts to maintain a "Special Reserve Bank Account for the Exclusive Benefit of Customers" with a bank (at all times when deposits are required). That account should be separate from any other bank account of the broker-dealer and should contain deposits in cash and qualified securities in amounts computed in accordance with the formula attached in exhibit A of SEC Rule 15c3-3.

5.190 Rule 15c3-3 provides a detailed formula for determining the reserve bank account requirement and designates when such computations should be made. The rule also requires a broker-dealer to promptly obtain physical possession or control of all fully paid securities and excess-margin securities carried for the accounts of customers, and it requires the broker-dealer to act within a specified time period when possession or control has not been established.

5.191 The auditor should review the broker-dealer's procedures and controls required by SEC Rule 15c3-3 and perform those tests considered necessary

to be satisfied that the procedures and controls (including the written documentation) provide reasonable assurance that the broker-dealer is in compliance with the rule.

Net Capital

5.192 SEC rules require all registered broker-dealers to comply at all times with the net capital requirements and to calculate net capital on a periodic basis to demonstrate compliance. *Net capital* is the broker-dealer's net worth, including allowable subordinated liabilities and other credits adjusted for nonliquid (nonallowable) assets, capital charges for operational items, and possible adverse fluctuations in the value of inventory (haircuts). The purpose of the net capital computation is to determine the broker-dealer's net liquid assets (minimum capital base) in the event of adverse business conditions. This minimum capital base is designed to protect (*a*) customers, (*b*) creditors, and (*c*) other broker-dealers.

5.193 The auditor should review the broker-dealer's procedures and controls covered by SEC Rule 15c3-1 and perform those tests considered necessary to be satisfied that the procedures and controls, including the written documentation, provide reasonable assurance that the broker-dealer is in compliance with the rule. If appropriate, the auditor may also want to consider the effect on the supplemental schedules of differences identified as a result of the audit of the basic financial statements. See paragraphs 4.18–.22.

Appendix A—Securities Broker-Dealers' Auditing Considerations[15,**]

5.194 The following table provides examples of substantive tests and tests of internal control, and the related audit objective and audit assertion(s), that an auditor may consider in the audit of a broker-dealer. This information is for illustrative purposes only. The tests actually performed in each audit engagement are based on an assessment of risk and other factors specific to the entity being audited.

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[15] AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), provides guidance on auditing fair value measurements and disclosures contained in financial statements. AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1), provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities, and investments in securities. In addition, the companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* provides practical guidance for implementing AU section 332. Practitioners may refer to the auditing considerations contained in the AU sections referred to previously and the companion Audit Guide for guidance on audit assertions, audit objectives, tests of controls, and substantive tests related to investments in securities, derivative instruments, and hedging activities. For audits conducted in accordance with GAAS, Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist," of AU section 332 (AICPA, *Professional Standards*, vol. 1, AU sec. 9332 par. .01–.04), provides that if the auditor determines that the nature and extent of auditing procedures should include tests of the measurement of investments in securities, simply receiving a confirmation from a third party does not, in and of itself, constitute adequate audit evidence with respect to the valuation assertion. The interpretation also provides that receiving confirmation from a third party for investments in aggregate does not constitute adequate audit evidence with respect to the existence assertion. Receiving confirmation from a third party on a security-by-security or investment-by-investment basis, however, typically would constitute adequate audit evidence with respect to the existence assertion.

[**] AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), recategorized assertions by classes of transactions, account balances, and presentation and disclosure. This table has been revised to reflect the new assertion categories.

Audit Areas	*Audit Assertions*	*Audit Objectives*	*Examples of Substantive Tests and Tests of Control*
Cash/Drafts Payable	Existence/ Completeness	Balances in cash (including segregated funds) and drafts payable accounts are fairly stated.	• Confirm balances (including accounts with zero balances). • Confirm compensating balance arrangements. • Test reconciliations. • Obtain subsequent bank statements and determine that transactions were recorded in the proper period.
	Completeness	Controls over cash receipts and disbursements are sufficient.	• Test compliance with controls including the following: — Daily cash balancing procedures. — Segregation of duties (for instance, independent reconciliation procedures, authorization, and controls over disbursements, including check and wire transfers). — Periodic independent reconciliation of accounts.
	Valuation and Allocation	Reserves are adequate to cover exposure resulting from aged reconciling debit items.	• Perform analytical procedures on aged reconciling items. • Understand reserve policy. • Determine that reserves are sufficient relative to exposures related to aged reconciling items.
	Classification	Cash (including segregated funds) and drafts payable are properly classified in the financial statements.	• Determine the appropriateness of financial statement presentation and related disclosures: — Drafts payable and cash accounts are only netted when right of setoff exists. — Cash segregated for regulatory purposes is correctly disclosed. — Marketable securities that are classified as cash equivalents satisfy the requirements for such classifications.
	Completeness	Cash- and drafts- payable balances reflect transactions recorded in the proper period.	• Obtain a schedule of deposits made prior to year-end but not recorded until subsequent to year-end. Agree items to year-end bank reconciliation. Items should appear as reconciling items. • For interbank transfers, ascertain that receipts and corresponding disbursements are both entered in cash records in the same period, noting dates of deposits and dates transfer checks were down.
Bank Loans	Existence/ Completeness	All bank loans have been identified and fairly stated.	• Confirm balances (including accounts with zero balances and collateral pledged). • Confirm letter-of-credit agreements. • Test reconciliations of bank statements to company records. • Obtain subsequent bank statements and determine that loans were recorded in the proper period.
	Classification	Bank loans are properly classified in financial statements.	• Determine the appropriateness of financial statement presentation and related disclosures: — Bank loan balances are properly classified. — Letters of credit and assets pledged are properly reported.
	Completeness	Bank loan balances are recorded in the proper period.	• Obtain and test interbank transfers and subsequent payments.

Customer Receivables and Payables	Existence/ Completeness	Customer-receivable and customer-payable amounts are fairly stated.	• Confirm selected customer account balances and positions through either positive or negative requests or a combination of both: — With positive confirmations, follow up with second requests for customer accounts not replying. — Follow up on the resolution of exceptions. — Perform alternate procedures when confirmations are not received. • Perform analytical procedures on balances by account type, such as DVP/RVP versus hold/custody accounts and margin versus cash accounts.
	Completeness/ Rights and Obligations	Controls over customer receivables and payables are sufficient.	• Test compliance with controls, including the following: — For openings of new accounts, appropriate customer approvals are obtained (for example, hypothecation loan agreement for margin accounts). — Trading and other activity in customer accounts are adequately monitored to ensure that unauthorized transactions are detected. — Transactions recorded in no-name (invalid) accounts are adequately monitored and resolved on a timely basis. — Procedures for monitoring trades and journal entries at branch offices are in effect. — Controls over changes to the name and address file are adequate. — Hold-all-mail (*holdout*) statements are supported by valid customer instructions. — Procedures for monitoring and resolving error statements are adequate. — Procedures for abandoned property accounts and compliance with state escheat laws are adequate. — Procedures for monitoring and resolving customer complaints are adequate. — Employee accounts are properly identified, monitored, and reported. — Customer statements are periodically mailed.
	Completeness	Trades are inputted timely and accurately.	• Determine that order matching procedures are adequate. • Determine that trade confirmations are sent to customers on a timely basis. • Test selected accounts for as-of-trades.
	Valuation and Allocation	Reserves are properly established to adequately reflect exposure from uncollectible receivables (debit balances plus short market value is greater than credit balances and long market value).	• Analytically determine exposure and reserve amounts for undermargined, partly secured, and unsecured customer accounts. • Obtain reserve policy and determine compliance. • Determine that reserves are sufficient relative to exposure.
	Classification	Customer-receivable and customer-payable amounts are properly classified in the financial statements.	• Determine the appropriateness of financial statement presentation and related disclosures: — Amounts are appropriately classified. — Customer receivables and customer payables are shown gross as appropriate. — Allowance for doubtful accounts is disclosed.
	Completeness	Customer transactions are accurately recorded in the appropriate period.	• Understand internal procedures associated with processing customer transactions. • Confirm selected customer account balances and positions.

(continued)

Audit Areas	*Audit Assertions*	*Audit Objectives*	*Examples of Substantive Tests and Tests of Control*
Receivables from/ Payables to Brokers and Dealers	Existence/ Completeness	Receivables from and payables to brokers and dealers are fairly stated.	● Confirm selected open fail-to-receive and fail-to-deliver transactions with the counterparties and resolve all exceptions. ● Confirm, balances in omnibus accounts for clearing and initiating brokers and resolve all exceptions. ● Perform analytical procedures on fail balances by counterparty and product type (equities, corporate bonds, and so forth.) ● Vouch documentation supporting the subsequent settlement of open transactions.
	Completeness	Controls over the clearance, settlement, balancing, and reconciliation of transactions are sufficient.	● Test compliance with controls, including the following: — Comparison and reconciliation procedures with custodian and clearing organizations such as the DTC, NSCC, and OCC. — Reconciling pending and settled trades. — Resolving uncompared trades. — Aging of open items — Identifying, monitoring and reporting exposure items.
	Existence/ Completeness	Reconciliations of subsidiary fail blotters to the general ledger and stock record are prepared completely and accurately, and are timely; and out-of-balances are researched and resolved timely.	● Test reconciliations: — Agree total position and money to stock record and trial balance. — Determine the resolution of reconciling items.
	Completeness	Money and securities received/delivered do not differ from recorded amounts.	● Test balancing procedures by comparing recorded cash activity and securities movements with banks and depositories to actual activity and movements.
	Valuation and Allocation	Reserves are properly established to adequately reflect exposure, that is, debit is greater than long market value (LMV) and short market value (SMV) is greater than credit.	● Test procedures for determining exposure to loss. ● Perform analytical procedures on aged items. ● Obtain reserve policy and determine compliance. ● Determine that reserves are sufficient relative to exposure.
	Classification	Receivables from and payables to brokers and dealers are properly classified in the financial statements.	● Determine the appropriateness of financial statement presentation and related disclosures: — Amounts are properly classified. — Amounts are appropriately shown gross.
	Completeness	Receivables from and payables to brokers and dealers are accurately recorded in the appropriate period.	● Determine that trade date adjustments are appropriately recorded. ● Vouch subsequent receipts to the counterparty statement on a test basis.
Securities Borrowed and Loaned	Existence/ Completeness	Securities loaned and securities borrowed are fairly stated.	● Confirm selected open transactions with the counterparty for money and related securities positions and resolve all exceptions. ● Confirm selected noncash borrow/loan (meaning, securities for securities).

	Completeness	Controls over securities borrowed and loaned are sufficient.	• Test compliance with controls, including the following: — Procedures for processing, settling, balancing, and reconciling regular and matched-book securities borrowed/loaned transactions. — Comparison procedures with LOANET or other system (see the glossary) — Procedures related to credit review policies.
	Existence/ Completeness	Reconciliations of subsidiary loan/borrow blotters to the general ledger and stock record are prepared completely and accurately, and are timely, and out-of- balances are researched and resolved timely.	• Test reconciliations: — Agree total position and money to stock record and trial balance. — Review the resolution of out-of-balances and reconciling items.
	Completeness	Money and securities received/delivered do not differ from recorded amounts.	• Test house balancing procedures. Compare recorded cash activity and securities movements with banks and depositories to actual activity and movements.
	Valuation and Allocation	Collectability and collateralization of receivables and short positions are adequate.	• Test the mark-to-market and collection procedures for additional margin requirements. • Test procedures for determining exposure to loss. • Determine that noncash collateral received in exchange for securities loaned is properly valued.
	Valuation and Allocation	Reserves are properly established to adequately reflect exposure (that is, debits are greater than LMV and SMV is greater than credits).	• Obtain reserve policy and test compliance. • Determine that reserves are sufficient relative to exposure.
	Classification	Securities loan and securities borrowed are properly classified in the financial statements.	• Determine the appropriateness of financial statement presentation and related disclosures: — Securities-loaned and securities-borrowed amounts are appropriately classified. — Amounts are shown gross.
	Completeness	Securities-borrowed and securities-loaned transactions are recorded in the proper period.	• Test listing of securities-borrowed and securities-loaned transactions entered into prior and subsequent to year-end. Determine that transactions are recorded in the proper periods.
Securities Owned and Securities Sold, Not Yet Purchased	Existence/ Completeness	Trade date inventory positions are accurate.	• Perform analytical procedures on account balances by product type. • Test internal control to ensure that the following: — Trader records are reconciled with the general ledger and stock record. — Branch orders are matched with trader order. — Trading limits and concentration restrictions are properly established and monitored. — Trader activity is adequately monitored by management. — When-issued, forward trades, financial futures, and standby commitments are properly monitored and reported.
	Completeness	Trades are timely and accurately inputted.	• Determine that trades are properly time-stamped. • Test select accounts for "as of" trades.

(continued)

Audit Areas	*Audit Assertions*	*Audit Objectives*	*Examples of Substantive Tests and Tests of Control*
	Valuation and Allocation	Trade date inventory is fairly stated at fair value.	• Test pricing procedures. • Agree prices for selected securities to independent sources with emphasis on positions with manual or override prices. Develop alternative procedures to determine the reasonableness of prices if no independent prices are available; examine recent/subsequent trading activity; or compare prices to similar securities based on maturity, rating, or other criteria • Recalculate interest and dividend accruals for selected securities in inventory. • Test inventory positions for concentrations in particular securities. • Test aging of inventory.
	Valuation and Allocation	Reserves are properly established to adequately reflect exposure (that is, debits are greater than LMV and SMV is greater than credits).	• Understand risk management procedures for monitoring overall exposure, including the use of hedges to reduce exposure to market risk. • Determine that reserves are sufficient relative to exposure.
	Rights and Obligations	Joint inventory positions are properly identified.	• Confirm selected joint inventory positions and test related controls.
	Classification	Accruals for inventory positions relating to unsettled trades are properly classified.	• Test controls over the generation of trade and date and settlement date inventory positions. • Test trade date/settlement date adjustment.
	Classification	Inventory positions are properly classified in the financial statements.	• Determine the appropriateness of financial statement presentation and related disclosures: — Securities inventory positions are properly classified as • Securities on deposit in compliance with regulatory requirements. • Securities owned. • Securities not readily marketable. • Securities sold, not yet purchased. • Joint inventory owned by other brokers and dealers.
	Completeness	Securities owned and securities sold, not yet purchased are accurately recorded in the appropriate period.	• Test "as of " trades subsequent to year end to ensure that they are reflected in the proper period.
Securities Purchased Under Agreements to Resell and Securities Sold Under Agreements to Repurchase	Existence/ Completeness	Repurchase (repo) and reverse repurchase (resale) amounts are fairly stated in financial statements.	• Confirm selected open repo and resale transactions with the counterparty, based on cash balances and related securities positions, and resolve all exceptions.

	Existence/ Completeness	Controls over securities purchased under agreements to resell and securities sold under agreements to repurchase are sufficient.	● Test compliance with controls, including the following: — Procedures for processing, settling, balancing and reconciling repo and resale transactions. — Identifying and resolving all out of balances. — Monitoring and reporting aged items. — Procedures related to credit review and collection policies.
	Completeness	Money and repo and resale positions do not differ from recorded amounts.	● Test house balancing procedures; compare anticipated cash activity and securities movements with banks and depositories to actual activity and movements.
	Valuation and Allocation	The collateralization of resales is adequate to cover exposure.	● Test procedures for the following: — Appropriateness of the market value of collateral positions. — Calculating interest accruals on collateral positions.
	Valuation and Allocation	Reserves are properly established to adequately reflect exposure.	● Obtain reserve policy and determine compliance. ● Determine that reserves are sufficient relative to exposure.
	Classification	Matched book repo and resale agreements are separately disclosed on the statement of cash flows.	● Determine the appropriateness of financial statement presentation and related disclosures: — Repurchase and resale amounts are appropriately classified. — Amounts are netted only if appropriate. — Matched book transactions are properly recorded. — Amounts are properly classified on the statement of cash flows.
	Completeness	Off-balance-sheet risks are sufficiently disclosed.	● Determine the appropriateness of financial statement presentation and related disclosures.
	Completeness	Securities purchases under agreements to resell and securities sold under agreements to repurchase are recorded in the proper period.	● Test procedures and controls over the processing of resale and repo transactions, which will include cash and security movements, segregation procedures, and balancing. ● Perform analytical procedures on repo and resale balances and related interest income and expense based on average balances and interest rates. ● On a test basis, sample these items, determining if the transaction was recorded in the proper period.
Suspense and Processing Accounts	Existence/ Completeness	Suspense and processing amounts are fairly stated.	● Perform analytical procedures on suspense account positions, money balances, and exposure amounts. ● Understand controls for processing the following: — Cash receipts and disbursements and securities movements from cash and box accounts with customer accounts and other general ledger accounts, such as fail and offset accounts. — Transactions in equities, fixed income, mutual funds, and foreign securities. — Conversion of foreign currency balances into U.S. dollars. — Intercompany transactions. — Unidentified and miscellaneous transactions.

(continued)

Audit Areas	*Audit Assertions*	*Audit Objectives*	*Examples of Substantive Tests and Tests of Control*
	Completeness	Controls regarding procedures for researching and resolving items in suspense accounts on a timely basis are sufficient.	● Determine the appropriateness of procedures for moving money and securities positions into suspense accounts: — Test the reconciliation of suspense accounts. — Test the resolution of selected suspense items. ● Understand procedures for monitoring and reporting the aging of suspense items. ● Test procedures for identifying and resolving money balances and positions in invalid accounts.
	Valuation and Allocation	Reserves are established to adequately reflect exposure (money and position) based on the nature and aging of individual suspense items.	● Monitor the periodic reduction of suspense-related exposure items. ● Determine that reserves are sufficient relative to exposure.
	Classification	Suspense and processing accounts are properly classified in the financial statements.	● Determine the appropriateness of financial statement presentation and related disclosures. ● Test the classification of suspense and processing account balances. ● Intercompany transactions are properly eliminated for financial statement purposes.
Reorganization Accounts	Existence/ Completeness	Reorganizations are properly identified.	● Perform analytical procedures on reorganization-related positions, money, and exposure amounts ● Test compliance with internal controls, including the following: — Procedures for processing, balancing , and reconciling reorganization account. — Proper notification of customers.
	Completeness	Reorganization money and positions do not differ from recorded amounts.	● Test house balancing procedures; compare anticipated cash activity and securities movements with banks and depositories versus actual activity and movements.
	Valuation	Controls are adequate over the reconciliation of reorganization accounts, including the identification of conversion ratio, ratio out-of-balance conditions.	● Test controls over the reconciliation of reorganization accounts. ● Test individual reorganizations for timely notification, proper processing of securities movements, and customer-related receipts/disbursements. ● Determine the appropriateness of conversion ratios for selected reorganizations to independent sources. ● Confirm selected reorganization transfers and test the related aging of these items.
	Valuation and Allocation	Reserve amounts are sufficient relative to exposure resulting from suspense related and aged items.	● Calculate exposure and monitor the reduction of such exposure. ● Test the determination of exposure for ratio out-of-balance conditions in reorganization accounts. ● Discuss pending litigation relating to missed tender offers with client's counsel. ● Determine that reserves are sufficient relative to exposure.
	Classification	Reorganization-related amounts are properly classified in the financial statements.	● Determine the appropriateness of financial statement presentation and related disclosures.

Deferred Investment Banking Revenues and Expenses/ Good Faith Deposits	Existence/ Completeness/ Cutoff	Deferred revenues, expenses and good-faith deposits from investment banking/underwriting deals are recorded in the proper period.	● Perform analytical procedures on deferred debits/credits and good-faith deposit amounts. ● Test compliance with controls for the following: — Expensing or recognizing deferred debits (expenses) and credits (revenues) on underwriting deals. — Performing final accountings on underwriting deals. — Communicating significant information relating to pending deals to the accounting department. — Allocating and recording expenses to be charged to syndicate members. ● Test selected deals recorded immediately before or after year-end to determine that the proper cutoff has been accomplished. ● Confirm selected good-faith deposits and resolve exceptions.
	Valuation and Allocation	Deferred debits and credit are properly aged.	● Test the aging of deferred debits. ● Test selected items for propriety.
	Valuation and Allocation	Reserves are properly established relative to exposure.	● Obtain reserve policy and determine compliance. ● Determine the adequacy of reserves.
	Cutoff	Revenues and expenses related to investment banking activity are recorded in the proper period.	● Test procedures for performing final accounting on underwriting deals, including revenue and expense allocations and the timeliness of their procedures. ● Test procedures for communicating significant information relating to pending deals to the appropriate financial units.
Dividend and Interest Receivables/ Payables	Existence/ Completeness	Dividend and interest receivables/payables are fairly stated.	● Perform analytical procedures on dividend and interest receivable/payable amounts. ● Understand the compliance with controls over recording, collecting, and disbursing dividends and interest to firm and customer accounts. ● Test the resolutions of selected dividend (stock and cash) and interest receivable and payable amounts by monitoring subsequent collections and payments. ● Test procedures for complying with state escheat laws.
	Completeness	Notification of dividends are properly detected, and only authorized transactions are recorded.	● Test controls related to — accurately recording dividend and interest accruals on record date, and payments on pay date. — identifying and recording unannounced dividends received. ● Test selected items for propriety to ensure that only authorized dividend and interest transactions are processed (that is, exclude customers who will receive payments directly from the paying agent).
	Valuation and Allocation	Cash and stock dividend and interest receivables are properly aged, and reserves that adequately reflect exposure are established.	● Perform analytical procedures on aged items. ● Test procedures for aging dividends and interest items and determining collectibility. ● Determine that reserves are sufficient relative to exposure. ● Determine the appropriateness of financial statement presentation and related disclosures: — Dividend and interest amounts are properly classified.

(continued)

Audit Areas	*Audit Assertions*	*Audit Objectives*	*Examples of Substantive Tests and Tests of Control*
	Cutoff	Dividends and interest receivables and payables are recorded in the proper period.	● Test procedures for recording dividends and interest receivables and payables. ● Test that the amounts recorded for dividends and interest are recorded in the proper period by recalculating stock dividends and bond interest on test basis and agreeing those amounts to the general ledger.
Securities Locations: ● Physical Vault ● Depositories ● Custodians ● In-Transit	Existence/ Completeness	Positions listed on the stock record as physically on hand, at depositories, at custodians, or at transfer agents are accurate.	● Test the periodic count of securities on hand, on deposit, and in transit through observation and confirmation. ● Confirm selected transfer positions with transfer agents for securities pending transfer of title, exchange, or redemption. ● Reconcile positions from stock record to custodian/depository statements.
	Existence/ Completeness	Differences discovered as a result of security counts or verifications are recorded and resolved on a timely basis.	● Test compliance with controls for the following: — Balance the stock record — Performing box reconciliations between actual positions and recorded positions ● Resolving security count differences
	Rights and Obligations	Withdrawals of securities from vault or box locations are authorized and valid.	● Test compliance with controls for the following: — Withdrawal of securities from the vault or box for deliveries by authorized personnel, — Segregation of duties between personnel responsible for balancing cash and related securities positions.
	Rights and Obligations	The movement of securities is properly recorded.	● Test procedures for recording securities movements between branches, custodians, and transfer agents. ● Test reconciliations of branch box positions with the recorded positions on the stock record.
Stock Record	Completeness	Positions listed on the stock record are complete.	● Test the stock record to ensure it balances. ● Test the arithmetic accuracy of the stock record for select securities.
Commission Revenue	Occurrence/ Completeness/ Accuracy	Commission revenue is fairly stated.	● Perform analytical procedures on commission revenue based on independent variables such as the following: — Commission rates (full and discounted) — Number of transactions and the average shares per trade — The retail/institutional mix — Industry trends ● Perform detail test of commission amounts for selected trades (test of transactions): — Agree to commission per trade ticket to approved commission rate schedule. — Agree to commission from ticket to daily summary. — Agree total per summary to appropriate general ledger account.
	Cutoff	Commission revenue is recorded in the proper period.	● Perform analytical procedures and analyze unusual variations: — Quarter-to-quarter — Year-to-year ● Beginning with source documentation, recalculate the commission revenue on a sample basis and agree the amounts to those recorded in the general ledger.

Principal Transaction Revenue	Occurrence/ Completeness/ Accuracy	Principal transaction revenue earned from firm trading is fairly stated.	● Perform detail test of realized revenue recognized on selected principal transactions: — Agree selected transactions to general ledger and stock record activity. — Determine the opening market value (cost basis) and the transaction price to recalculate the gain or loss on the selected transactions. — Agree the realized gain or loss to the daily summary. ● Perform detail test of unrealized gains and losses by verifying closing prices to independent price sources and recalculating daily profit and loss (P&L) for selected principal transactions.
	Cutoff	Principal transaction revenue is recorded in the proper period.	● Perform analytical procedures and analyze unusual variances: — Quarter-to-quarter — Year-to-year ● Beginning with source documentation, recalculate the principal transactions revenue on a sample basis and agree the amounts to the general ledger.
Interest Revenue/ Expense	Occurrence/ Completeness/ Accuracy	Interest revenue/expense on firm positions and customer margin accounts are fairly stated.	● Perform analytical procedures on interest revenue/expense based on the following: — Weighted average balances in customer margin, firm inventory, stock borrow/loaned, and repo/resale accounts — Weighted average balances outstanding in commercial paper, bank loans — Average interest rates
	Cutoff	Interest revenue and expenses are recorded in the proper period.	● Perform analytical procedures and analyze unusual variances: — Quarter-to-quarter — Year-to-year ● For interest revenue, beginning with source documentation, recalculate interest revenue on a sample basis and agree the amounts to the general ledger. ● For interest expense, beginning with the general ledger balances, agree the amounts to source documentation and recalculations.
Investment Banking Underwriting Revenue	Occurrence/ Completeness/ Accuracy	Revenues, expenses, and good-faith deposits from underwriting deals are fairly stated.	● Perform analytical procedures on investment banking revenue as it relates to the following: — Number and average size of transactions — The equity/fixed- income underwriting mix — Industry trends for underwriting fee percentages ● Perform detail test of selected deals, as follows: — Obtain client files for selected deals. — Agree all pertinent details from prospectus to client files (that is, amount of issue, fees per unit). — Recalculate underwriting fees for the selected deals based on independent documentation. — Agree to appropriate general ledger account and investigate material variance.

(continued)

Audit Areas	*Audit Assertions*	*Audit Objectives*	*Examples of Substantive Tests and Tests of Control*
	Completeness	Final accounting for managed underwriting deals, including the allocations of expenses, are completed on a timely basis.	● Test procedures for performing final accountings on underwriting deals (that is, expense allocations and timeliness).
	Valuation and Allocation	Reserves are properly established to adequately reflect exposure.	● Determine whether reserves are adequate relative to exposure (that is, litigation contingencies).
	Classification	Investment banking revenue and expenses are properly classified in the financial statements.	● Determine the appropriateness of financial statement presentation and related disclosures.
	Cutoff	Investment banking revenue is accurately recorded in the proper period.	● Recalculate the recorded revenue amounts and determine whether the amounts were recorded in the proper period.
Compensation Expense	Occurrence/ Completeness/ Accuracy	Compensation expense is fairly stated.	● Perform analytical procedures on compensation amounts for salaries and commission employees based on the following: — Number of employees — Average salary increases — Total commission revenue versus commission payouts — Additional incentive compensation plans ● Perform test of compensation expense based in independent records maintained by the personnel department. ● Test incentive compensation schedule and reconcile payroll amounts to the general ledger and financial statements.
	Classification	Compensation expense is properly disclosed in the financial statements.	● Determine the appropriateness of financial statement presentation and related disclosures. — Pension-related amounts are properly disclosed. — Applicable amounts are confirmed with an actuary.
	Cutoff	Compensation expenses incurred are recorded in the proper period.	● Test subsequent payroll checks to employees on a sample basis to ensure that the compensations expense related to the payment was recorded in the proper period.

Other Expenses: ● Brokerage and Clearing ● Depreciation ● Occupancy ● Communications ● Professional Fees ● Advertising ● Supplies	Occurrence/ Completeness/ Accuracy	Other expenses are fairly stated.	● Perform analytical procedures on expense amounts based on relevant variables and relationships. ● Perform test of transactions on selected expense items; agree supporting documentation to recorded amounts. ● Recalculated depreciation and amortization amounts.
	Cutoff	All other expenses incurred are recorded in the proper period.	● Test subsequent payments to determine that expenses paid are recorded in the proper period.
Taxes	Occurrence/ Completeness/ Accuracy	Tax expense is fairly stated.	● Tax personnel scan the reconciliation of book income to taxable income. ● Determine whether documentation supports permanent and temporary tax differences.
Regulatory	Rule 15c3-1	Net capital is properly computed and minimum requirements met, in accordance with SEC Rule 15c3-1.	● Test procedures for compliance with the net capital requirements of SEC Rule 15c3-1. ● Perform analytical procedures on the net capital computation, including the following: — Nonallowable assets — Subordinated debt added — Haircuts and capital charges deducted ● Test nonallowable (illiquid) assets deducted in the net capital computation as follows: — Other broker-dealer receivables — Loans to affiliates — Property, plant, and equipment — Other nonallowable assets ● Test procedures for determining and reporting the following items: — Net debit cash reconciling items aged over seven business days — Dividend-and interest-related aged items — Fail-to-receive/deliver, securities loaned/borrowed, and repo/resale items — Suspense-related aged items — Unsecured and partly secured amounts in margin customer accounts ● Determine that allowable receivables from other broker-dealers are covered by PAIB agreements. ● Test the procedures for compliance with capital charges related to buy-in provisions for foreign securities. ● Read agreements from the examining authority supporting selected subordinated liabilities treated as *good capital* for the net capital computation. ● Confirm subordination agreements. ● Determine for fixed assets collateralizing intercompany loans that the net book value, is sufficient to meet regulatory requirements.

(continued)

Audit Areas	*Audit Assertions*	*Audit Objectives*	*Examples of Substantive Tests and Tests of Control*
		Net capital is properly reduced for haircuts on firm inventory positions.	● Test selected haircuts deducted in the net capital computation, as follows: — Determine that classifications are proper based on type of securities and maturity for fixed-income products. — Determine that securities with a limited market, unregistered securities, and securities with below-investment-grade ratings are properly reported and receive the proper haircut. — Recalculate haircuts using percentages found in Rule 15c3-1, including reductions for hedges. ● Read the Financial and Operational Combined Uniform Single (FOCUS) report and agree totals from the general ledger to supporting schedules and totals from such schedules to the FOCUS report.
	Rule 15c3-3	Possession and control (P&C) requirements are met in accordance with SEC Rule 15c3-3.	● Test compliance with procedures for obtaining and maintaining possession or control of all fully paid and excess-margin securities of customers: — For tests and coding of accounts on the company's segregation system, (1) determine that accounts coded as good control satisfy the requirements of SEC Rule 15c3-3, (2) determine that other short positions are properly coded (for example, stock loan, fails to receive, bank loan), (3) verify that the customer margin and cash account are appropriately classified (select accounts), (4) determine that other accounts that are required to be segregated are appropriately coded (for example, suspense, difference, unclaimed dividends should be treated as fully paid by the customer). — Recompute the value of securities required to be segregated for select accounts and verify that instructions were issued. — Recompile the allocation of securities for determining whether the appropriate quantity of securities are segregated. — Test the pricing of securities. ● Test procedures for recording due bill repos and compliance with possession or control requirements. ● Test procedures to prevent the creation or increase of a segregation deficit. Select individual deliveries to verify that deficits are not created or increased. ● Test procedures for buying-in fails-to-receive and aged stock dividend receivables and recalls of securities loaned. ● Test procedures for identifying and buying-in customer cash shorts (sales not long) aged over 10 business days from the settlement date.
		Segregated cash is sufficient to meet the requirements of the reserve formula computation in accordance with SEC Rule 15c3-3.	● Perform analytical procedures on the reserve formula computation. ● Test computation for determination of reserve requirements. ● Test that cash or qualified securities are deposited as required on a timely basis. ● Recompute the allocation of fails, securities loaned/borrowed, bank loans, firm inventory and customer shorts, repos and resales for select securities. ● Determine that documentation demonstrates that the special reserve bank account is for the exclusive benefit of customers.

	Federal Reserve Regulation T and NYSE Rule 431[††]	Requirements of Regulation T and NYSE Rule 431 are being complied with for all customer cash and margin accounts.	• Test initial and maintenance margin requirements under "house rules" for various products to determine compliance with Regulation T and NYSE Rule 431. • Test the pricing of securities used in the margining of customer accounts. • Test selected customer margin accounts to determine that a minimum amount of equity is maintained in the account. • Test selected transactions recorded in customer cash accounts to determine that funds/securities (for purchase/sales) have been received within seven days of trade date. • Test procedures for determining and issuing maintenance calls for funds collections. • Test selected calls to determine that funds/securities have been received within five business days from the date of issue. • Test procedures for filing extensions with the regulatory agencies if maintenance calls are not paid on a timely basis.
	Rule 17a-13	Quarterly examinations, counts, verifications, and comparisons of securities on hand, on deposit, in transit, out of transfer, and pledged as collateral, are performed as required by Rule 17a-13.	• Observe and test the quarterly count/comparison of securities on hand, on deposit, in transfer, or in transit.
		Fails, securities loaned and borrowed, and securities pledged aged over thirty calendar days and transfer items over forty days are subject to verification through confirmation.	• Test confirmation replies of security positions over thirty calendar days old.
Off-Balance-Sheet Items	Existence/ Completeness	All items with off-balance-sheet risk are valid and properly identified and monitored. Products classified as off-balance-sheet items are entitled to such treatment.	• Test compliance with relevant controls, including the following: — Documentation that is maintained for each contract — Authorization structure for approving off-balance-sheet transactions — Review procedures in place for periodically monitoring open commitments to determine if all commitments are valid and properly authorized and valued • Confirmed terms of each transaction on a sample basis, based on exposure relative to each of the open commitments. • Test selected signed contracts.
	Valuation and Allocation	Reserves are properly established to adequately reflect exposure due to credit and market risks.	

[††] Financial Industry Regulatory Authority (FINRA) Rule 4210, *Margin Requirements*, was introduced with the filing of SR-FINRA-2010-024 and has been approved by the SEC. The effective date has not yet been determined. Upon the effective date of the rule, NYSE Rule 431 will no longer be applicable.

5.195

Appendix B—Consideration of Fraud in a Financial Statement Audit: Examples and Considerations for Auditors of Brokers and Dealers in Securities

Risk Factors and Auditor Responses (see paragraphs 5.81 and 5.93*b* of the guide)

Two types of fraud are relevant to the auditor's consideration: fraudulent financial reporting and misappropriation of assets. For each of these types of fraud, the risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: incentives/pressures, opportunities, and attitudes/rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

Part 1: Fraudulent Financial Reporting

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions are present in entities where specific circumstances *do not present a risk of material misstatement.* Also, specific controls may exist that mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

A. Incentives/Pressures

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
    - *a.* High degree of competition or market saturation, accompanied by declining margins.
        - i. High-degree of competition relating to bank-owned broker-dealers that have been granted expanded powers to engage in securities activities or registered investment companies/mutual funds, accompanied by declining margins.
    - *b.* High vulnerability to rapid changes, such as changes in technology, or interest rates.
        - i. A failure or inability to keep pace with the rapid growth in electronic trading, if the financial stability or profitability of the particular entity is placed at risk, due to that failure or inability.
        - ii. Concentration in a particular type of financial instrument.
    - *c.* Unusually high level of "soft dollar" brokerage activities.
2. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

  - *a.* The pressure on management to meet the expectations of analysts and rating agencies or parents (for broker-dealers that are subsidiaries of banks or overseas entities).

3. Management or those individuals charged with governance's personal net worth is threatened by the entity's financial performance arising from the following:
   - *a.* The structure of incentive plans induces traders to take unusually greater risks.
   - *b.* There is unusually high level of internal competition for capital allocation among product types/trading desks.
4. Research analysts are not independent. Their compensation is controlled by investment banking or other areas for which the firm receives fees from covered companies.
5. Extensive benefits are provided to money managers that may drive fraudulent behavior. The value of such benefits is included in the commissions generated by customers on trades directed by money managers.
6. There are certain arrangements between the broker who directs the trade and the market maker who executes the trade that are not in the best interest of the customer.

B. Opportunities

1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:
   - *a.* A failure by management to have an adequate understanding of the entity's trading and investment strategies as conducted by the entity's traders, including the types, characteristics, and risks associated with the financial products purchased and sold by the entity.
   - *b.* Significant, unusual, or highly complex transactions, especially those close to year end that pose difficult "substance over form" questions.
     - i. Unusually significant increase in unsettled trades at year end.
     - ii. A high degree of complex accounting standards relating to, for example, financial instruments and off-balance sheet transactions.
     - iii. Transactions (straddling) year end in similar securities.
2. Internal control components are deficient as a result of the following:
   - *a.* Inadequate monitoring of controls, including automated controls and controls over interim financial reporting.
     - i. A failure by management and those charged with governance to set parameters (for example, trading limits, credit limits, and aggregate market risk limits) and to continuously monitor trading activities against those parameters.

ii. Lack of sufficient access controls for front-office and back-office systems.

iii. Lack of adequate "Chinese Wall" between investment banking and trading (that is, potential for insider trading).

iv. Failure to monitor the filling of customer orders from the firm's inventory (for example, front-running and excessive mark-up).

v. Lack of review of customer lists and insufficient controls surrounding the customer account approval and maintenance processes for both cash and margin accounts.

vi. A lack of sufficient controls over the review process for new products, structured finance, and off-balance-sheet transactions.

vii. A lack of sufficient controls over the valuation process for less liquid securities, including controls over the changes of valuation pricing and the appropriate segregation of duties.

b. High turnover rates or employment of ineffective accounting, internal audit, or information technology staff.

i. A failure by management to ensure that the brokers are properly trained, appropriately licensed, and adequately supervised.

ii. Lack of policies and training over the range of product offerings.

iii. A failure by management to assess the quality and breadth of the company's internal audit department, to ensure that the department receives adequate training and resources to match the sophistication and progression of the company.

iv. Improper reporting lines for internal audit.

c. Ineffective accounting and information systems, including situations involving deficiencies in internal control and material weaknesses.

i. Lack of approval by those charged with governance and a specialist's independent evaluation of in-house developed valuation models.

d. Use of error accounts to hide trading errors, made to meet commitments to clients, particularly for block trades in meeting a predetermined value-weighted average price (VWAP).

e. Use of valuation reserves for other purposes, such as to hide errors or expenses. Assumptions in valuation reserves may be changed without adequate approval. Lack of proper approval for the establishment of valuation reserves.

f. Inappropriate use of customer collateral for firm purposes (tested by possession or control procedures).

g. Intercompany transactions designed to improperly manage earnings.

h. Transactions accounted for as sales as opposed to financing.

i. Use of different valuations of same product in two related companies.

j. Use of a borrowed security to cover a theft of customer-related security.

k. Poor controls over corporate actions in which the client fails to receive entire benefit.

l. Not properly valuing collateral or reflecting the extent of cross-collateralization on rate swaps.

m. Weak controls causing a failure to record trades on a timely basis, which may facilitate customers' poor trading activity.

n. Lack of controls over the execution of customer transactions.

C. Attitudes/Rationalizations

Risk factors reflective of attitudes/rationalizations by those charged with governance, management, or employees that allow them to engage in or justify fraudulent financial reporting, may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

1. Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.

   a. Unusually aggressive interpretations of regulatory rules (for example, net capital rules and weekly reserve formula) when the company is reaching minimum net capital required by the Securities and Exchange Commission (SEC).

   b. Lax attitude toward regulatory compliance (example: security segregation requirements).

D. Auditor Responses

In addition to the sample responses presented in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), an auditor may want to consider the following responses:

- Extend confirmation procedures concerning agreements with counterparties (for example, leases, clearing, custody, margin, and subordinated debt).
- Extend confirmation procedures concerning the terms of selected transactions (for example, swaps, financing transactions, and fails) with counterparties.
- Review the results of valuation testing performed by departments of the company (for example, controllers, internal audit, and middle office).
- Review background information about those individuals charged with governance and management to determine if they have the

capacity to understand trading and investment strategies. Conversations with appropriate people and review of the experience and credentials of those charged with governance and management may be necessary.

- Review management summary reports on performance and meet with management to discuss trading and business direction.
- Perform periodic reviews of valuation methodologies by independent specialists throughout the year.
- Meet with middle office personnel to gain an understanding of the company's policies concerning managing risk (for example, stress testing and valuations).
- Extend testing on regulatory computations for companies barely meeting the minimum net capital requirements.
- Extend testing of the entity's "soft dollar" arrangements to ensure compliance with the SEC rules and regulations.
- How management dealt with regulatory issues in the past.
- How management responded to past regulatory examinations.
- Inquire whether there is a code of conduct.

Part 2: Misappropriation of Assets

An auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions are present in entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

Risk factors that relate to misstatements arising from misappropriation of assets are also classified along the three conditions generally present when fraud exists: incentives/pressures, opportunity, and attitudes/rationalizations. Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and weakness in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exists. The following are examples of risk factors related to misstatements arising from misappropriation of assets.

A. Opportunities

1. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:
    a. Securities (for example, bearer instruments) held in the company's vault.
    b. Commingling of customer securities with the entity's securities at a custodian bank.
2. Inadequate internal control over assets may increase the susceptibility to misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

a. Inadequate management oversight of employees responsible for assets.

   i. Lack of management oversight of extensive retail branches, or overseas branches and subsidiaries.

   ii. Inadequate supervision of traders' trading practices and limits, especially for those generating a large proportion of the entity's total revenue.

   iii. Large amounts of cash or securities at branches or branch offices.

   iv. Poor control over wire transfers.

b. Inadequate segregation of duties or independent checks.

   i. Lack of segregation of duties between the front-office (that is, execution of trades) and the back-office (that is, settlement and accounting for trades).

   ii. Lack of independent review of periodic reconciliations (for example, settlement accounts, cash accounts, and stock records).

   iii. Failure to confirm failed transactions on a timely basis.

   iv. Failure to periodically review items in suspense accounts.

   v. Failure to review the aging of items, including failed transactions and receivables.

   vi. Lack of or infrequent independent pricing of inventory performed by middle-office or back-office (that is, risk management and controller's group).

   vii. Poor controls over journal entries to customer accounts.

   viii. Failure to confirm customer transactions on a timely basis.

c. Inadequate physical safeguards over cash, investments, inventory, or fixed assets.

   i. Lack of safeguarding and insuring securities in transfer.

   ii. Lack of sufficient access controls for cash wiring systems.

d. Lack of timely and appropriate documentation of transactions.

   i. Lack of documentation related to "soft dollar" brokerage activities.

   ii. Lack of documentation related to derivative transactions with counter parties, such as ISDA master agreements.

e. Lack of controls relating to the rehypothecation of securities.

B. Auditor Responses

In addition to the sample responses presented in AU section 316, an auditor may want to consider the following responses.

- Review exception and break reports for settlement activities.
- Ensure that the compliance function reviews the personal account statements of the company's employees.
- Extend testing of access controls of online fund wiring system terminals.
- Review revenue trend of an individual trader over a period of time.
- Review level of errors and broker chargebacks of commissions.
- Look at controls over dealing with customer complaints.

Unusual or Unexpected Relationships (see paragraph 5.84 of the guide)

Examples of unusual or unexpected relationships that may indicate a material misstatement due to fraud may include the following:

- Recognition of unusually high unrealized gains on financial instruments at financial statement date.
- High volume of transactions around financial statement date.

Accounts, Classes of Transactions, and Assertions (see paragraph 5.87 of the guide)

Examples of accounts, classes of transactions and assertions that may have high inherent risk, involve a high degree of management judgment and subjectivity and be susceptible to manipulation by management:

- Valuation of inventory.
- Litigation reserves.
- Intercompany transactions.
- Valuation of collateral.
- Bonus determinations.
- Use of special-purpose entities.

Improper Revenue Recognition (see paragraph 5.88 of the guide)

Examples of improper revenue recognition may include:

- Incorrect valuation of inventory.
- Transactions between related entities designed to improperly manage earnings.
- Accelerating or deferring revenue to other periods.

Key Estimates (see paragraph 5.90 of the guide)

Examples of key estimates for brokers and dealers in securities may include:

- Valuation of inventory.
- Litigation reserves.

- Bonus determinations.
- Determination of carrying amount of goodwill.
- Realization of deferred tax assets.

Programs and Controls (see paragraph 5.91 of the guide)

Examples of programs and controls for brokers and dealers in securities may include:

- Code of conduct.
- Risk monitoring procedures for credit risk and market risk.

Chapter 6

Internal Control[1]

Auditor's Understanding of Internal Control in a Financial Statement Audit[2]

6.01 The regulatory environment has a major effect on the audit of a broker-dealer because of the requirements that the auditor report on the adequacy of the broker-dealer's internal control in accordance with Securities and Exchange Commission (SEC) Rule 17a-5(g)(1) and on its compliance with specific rules addressing financial responsibility and recordkeeping. Auditors of issuers are also required to audit and report on management's assessment of the company's internal control over financial reporting in conjunction with their audit of the company's financial statements. Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Standards, AU-P sec. 320), establishes requirements and provides directions that apply when an auditor is engaged to audit both a company's financial statements and management's assessment of the effectiveness of internal control over financial reporting. Paragraph .42 of AU-P section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*, Standards),[*] states that for purposes of evaluating the effectiveness of internal control over financial reporting in accordance with PCAOB standards, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit. Moreover, paragraph B2 of appendix B of Auditing Standard No. 5 (AU-P sec. 320) states that the auditor may be required to test the design and operating effectiveness of some controls he or she might not test if expressing an opinion only on the financial statements. Paragraph 6 of PCAOB Audit-

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[1] Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface). The preface also discusses the Sarbanes-Oxley Act requirement that *all* broker-dealers (both public and private) be audited by a public accounting firm registered with the Public Company Accounting Oversight Board (PCAOB).

As applicable, this chapter contains referencing to either the AICPA or the PCAOB professional standards. Refer to the preface for more information on referencing.

[2] For additional nonauthoritative guidance pertaining to internal control and the risk assessment standards (Statement on Auditing Standards Nos. 104–111 [AICPA, *Professional Standards*, vol. 1]), refer to Technical Questions and Answers sections 8200.05–.16 (AICPA, *Technical Practice Aids*).

[*] On August 5, 2010, the PCAOB adopted a suite of eight auditing standards related to audit risk. These standards, Auditing Standards No. 8–15, set forth requirements that enhance the effectiveness of the auditor's assessment of, and response to, the risks of material misstatement in the financial statements. The standards address audit procedures performed throughout the audit, from the initial planning stages through the evaluation of audit results. The standards, upon approval by the Securities and Exchange Commission (SEC), will become effective for audits of fiscal periods beginning on or after Dec. 15, 2010.

The suite of standards supersede six PCAOB interim standards and related amendments: AU-P section 311, *Planning and Supervision*; AU-P section 312, *Audit Risk and Materiality in Conducting an Audit*; AU-P section 313, *Substantive Tests Prior to the Balance Sheet Date*; AU-P section 319, *Consideration of Internal Control in a Financial Statement Audit*; AU-P section 326, *Evidential Matter*; and AU-P section 431, *Adequacy of Disclosure in Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Standards).

ing Standard No. 5 (AU-P sec. 320 par. .06) states that the audit of internal control over financial reporting should be integrated with the audit of the financial statements. The objectives of the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits. The auditor should design his or her testing of controls to accomplish the objectives of both audits simultaneously

- to obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of the year-end, and
- to obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of financial statements.

6.02 The early sections of this chapter discuss the auditor's understanding of internal control in auditing a broker-dealer's financial statements. The "Broker-Dealer Control and Monitoring Activities" section, beginning at paragraph 6.46, provides an overview of the types of control and monitoring activities that are unique to brokers-dealers. This guide is not intended to provide guidance to auditors on how to comply with the requirements of PCAOB Auditing Standard No. 5 (AU-P sec. 320), although it highlights, as appropriate, some of the additional requirements imposed by that standard. The term *audit* generally refers to the audit of financial statements unless it is indicated that the discussion pertains to the integrated audit or audit of internal controls.

6.03 As discussed in chapter 5, "Auditing Considerations," of this guide, the second standard of fieldwork states that the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), states that the auditor should obtain an understanding of the five components of internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to

a. evaluate the design of controls relevant to an audit of financial statements.

b. determine whether they have been implemented.

In obtaining this understanding, the auditor considers how an entity's use of IT and manual procedures may affect controls relevant to the audit of financial statements. IT encompasses automated means of originating, processing, storing, and communicating information, and includes recording devices, communication systems, computer systems, and other electronic devices. The auditor is primarily interested in the entity's use of IT to initiate, authorize, record, process, and report transactions or other financial data.

6.04 The auditor should use the understanding to

- identify types of potential misstatements.
- consider factors that affect the risks of material misstatement.
- design tests of controls, when applicable, and substantive procedures.

6.05 Obtaining an understanding of controls is a separate process from testing the operating effectiveness of controls. The objective of obtaining an understanding of controls is to evaluate the design of controls and determine whether they have been implemented for the purpose of assessing the risks of material misstatement. In contrast, the objective of testing the operating effectiveness of controls is to determine whether the controls, as designed, prevent or detect a material misstatement.

6.06 Paragraph .41 of AU section 314 defines *internal control* as a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

a. The reliability of the entity's financial reporting

b. The effectiveness and efficiency of the entity's operations

c. The entity's compliance with applicable laws and regulations

6.07 There is a direct relationship between an entity's objectives related to financial reporting, operations, and compliance, and the components of internal control it implements to provide reasonable assurance about their achievement. The following are the five interrelated internal control components:

a. *Control environment* sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

b. *Risk assessment* is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how to manage the risks.

c. *Control activities* are the policies and procedures that help ensure that management directives are carried out.

d. *Information and communication* systems support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

e. *Monitoring* is a process that assesses the quality of internal control performance over time.

Refer to paragraphs .40–.101 of AU section 314 for a detailed discussion of the internal control components in addition to the guidance provided in the following section. Refer to chapter 5 of this guide for guidance on designing and performing further audit procedures, which includes tests of controls.

The Control Environment

6.08 The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the following:

- Communication and enforcement of integrity and ethical values
- Commitment to competence
- Participation of those charged with governance
- Management's philosophy and operating style

- Organizational structure
- Assignment of authority and responsibility
- Human resource policies and practices

6.09 The control environment comprises the conditions under which the broker-dealer's information and communication system, the risk assessment process, monitoring, and control activities are designed, implemented, and function.

6.10 The control environment represents the collective effect of various factors on the overall effectiveness of the broker-dealer's internal control. These factors include the following:

- Management's personal characteristics, philosophy, and operating style and its commitment to accurate financial reporting have a significant influence on the control environment, particularly if management is dominated by one or a few individuals. A positive tone at the top is an important prerequisite to accurate and complete financial reporting. In a broker-dealer, compliance and control over legal matters are important indicators of the overall philosophy held by senior management. Management's approach to taking and monitoring business risks and its commitment to accurate financial reporting are other indications of the tone at the top. Management's commitment to accurate financial reporting may influence the activities of employees throughout the organization. Likewise, the types of activities that a broker-dealer engages in, as well as the amount of risk they are willing to take, affect their operating style. For example, the following business activities may affect management's operating style:
  - — Retail brokerage
  - — Discount brokerage
  - — Trading and market making
  - — Venture capital
  - — Merchant banking
  - — Underwriting initial public offerings (IPOs)
- The external business and regulatory environment motivates management to establish and maintain effective internal control in a broker-dealer. For example, examinations by self-regulatory bodies and their enforcement powers, as well as review of compliance reports by the SEC and other governmental bodies, motivate the management of broker-dealers to establish effective controls. In addition, regulatory minimum books and records requirements mandate that certain control activities be in place and documented.
- Management's commitment to designing and maintaining reliable accounting and stock record systems has a significant influence on the control environment. A low level of management concern about acceptable business practices, as well as deficiencies in controls, may lead a broker-dealer's employees either to adopt a similarly low level of concern or to attempt to take advantage of deficient controls. The reliability of information systems and the

effectiveness of controls may be impaired as a result. Personnel policies may enhance or inhibit the competence and continuity of the broker-dealer's employees. An inadequate or incompetent staff that is unable to process transactions and perform control activities may lead to a reduction in the reliability of information systems and the effectiveness of controls. In order to understand the degree of management's commitment to the design and maintenance of effective internal control and reliable accounting and stock record systems, the auditor might review the guidance in AU section 314 related to the following broker-dealer policies:

- — Systems security (including logical access and change management controls)
- — Trading limits
- — Sales practices
- — Hiring practices
- — Risk monitoring
- — Management's response and corrective action taken with respect to material inadequacies in internal control

- Management's ability to control the business also influences the control environment. In addition, the responsibilities of those charged with governance are of considerable importance. The auditor should consider such matters as the independence of the directors, their ability to evaluate the actions of management, and whether there is a group of those charged with governance that understands the entity's business transactions and evaluates whether the financial statements are presented fairly in conformity with U.S. generally accepted accounting principles (GAAP). The control environment will generally be stronger when those charged with governance take an active role in overseeing a broker-dealer's accounting and financial reporting practices, as well as those practices regarding the prevention of illegal acts and compliance with laws and regulations. To understand the ability of a broker-dealer's management to control the business, an auditor should consider the following:

  - — The broker-dealer's organizational and governance structures
  - — The methods used by the broker-dealer in assigning authority and responsibility
  - — The ability of the broker-dealer's management to supervise and monitor operations effectively
  - — The methods used by senior management to monitor and control the effectiveness of the accounting system and controls

Understanding the Control Environment

6.11 When obtaining an understanding of the control environment, the auditor should consider the collective effect on the control environment of strengths and weaknesses in various control environment elements.

Management's strengths and weaknesses may have a pervasive effect on internal control. For example, an active and independent board of directors may influence the philosophy and operating style of senior management. Alternatively, management's failure to commit sufficient resources to address security risks presented by IT may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or by allowing unauthorized transactions to be processed. Similarly, human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may not mitigate a strong bias by top management to overstate earnings.

6.12 The auditor should obtain sufficient knowledge of the control environment to understand the attitudes, awareness, and actions of management and those charged with governance concerning the broker-dealer's internal control and its importance in achieving reliable financial reporting. In understanding the control environment, the auditor should concentrate on the implementation of controls because controls may be established but not acted upon. For example, management may establish a formal code of conduct but act in a manner that condones violations of that code.

6.13 In obtaining an understanding of the control environment, the auditor gains knowledge about the overall attitude, awareness, and actions of management, those charged with governance, and others concerning the importance of control and its emphasis within the broker-dealer. The consideration of these items (management's attitudes, awareness, and actions related to compliance matters that might affect the broker-dealer's financial statements and supplementary schedules) is of particular importance in the design of a smaller entity's control environment. See chapter 5 of this guide for a discussion of the effect of IT on internal control.

Risk Assessment for Financial Reporting Purposes

6.14 A broker-dealer's risk assessment for financial reporting purposes is its identification, analysis, and management of risks relevant to the preparation of financial statements that are fairly presented in conformity with U.S. GAAP. For example, risk assessment may address how the broker-dealer considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions. Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect a broker-dealer's ability to initiate, authorize, record, process, and report financial data consistent with the assertions of management in the financial statements. Once risks are identified, management considers their significance, the likelihood of their occurrence, and decides upon actions to manage them. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

- *Changes in operating environment*. Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- *New personnel*. New personnel may have a different focus on or understanding of internal control.

- *New or revamped information systems*. Significant and rapid changes in information systems can change the risk relating to internal control.
- *Rapid growth*. Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- *New technology*. Incorporating new technologies into operating processes or information systems may change the risk associated with internal control.
- *New business models, products, or activities*. Entering into business areas or transactions with which a broker-dealer has little experience may introduce new risks associated with internal control.
- *Corporate restructurings*. Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- *Expanded foreign operations*. The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- *New accounting pronouncements*. Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

6.15 Broker-dealers devote a significant amount of time and resources toward the identification, quantification, analysis, and control of risk. A broker-dealer's control and monitoring activities are concerned with mitigating business risks and exposures. *Risk* refers to the likelihood that a loss might occur, whereas *exposure* refers to an amount (or other element) at risk. The decision to incur business risk rests with the broker-dealer's management. The following is an overview of the major risks and exposures facing a broker-dealer.

6.16 *Operational risk*. Operational risk arises in processing broker-dealer transactions. Exposure can be created by a failure to either process transactions properly or safeguard securities adequately. If operational risk is properly managed, other risks will be mitigated. In viewing operational exposure, it is important to look at the broad exposure within particular accounts, such as suspense accounts, difference accounts, reconciling items (for any accounts), and aged transfers and fails. For instance, within a particular suspense account, the exposure is frequently not the net balance in the account. A more accurate view of exposure is to identify debit-only items (no related security positions), short-market-value-only items (no related money balance), debit money with long market value, and credit money with short market value. By viewing each of those items separately, the auditor will better understand the total exposure.

6.17 *Credit risk*. Credit risk refers to potential losses arising from the failure of another party to perform according to the terms of a contract (counterparty default).

6.18 Credit risk can be customer- or broker-related. The exposure to the broker-dealer is for the amount of extended credit that is not fully collateralized. Therefore, obtaining adequate collateral from the counterparty could help minimize credit risk. An extension of credit can result in any of the following

transactions: margin transactions, cash transactions prior to settlement, stock borrows and stock loans, resale and repurchase agreements (repos), swaps, futures, forwards, options, and similar items. Broker-dealers will usually have credit committees, which set limits for total credit lines, exposure, and collateral requirements for any particular counterparty.

6.19 *Market risk*. Market risk refers to potential losses from fluctuations in market prices that may make a financial instrument less valuable or more onerous. A change in market price may occur (for example, for interest-bearing financial instruments) because of changes in general interest rates (interest rate risk), changes in the relationship between general and specific market interest rates (an aspect of credit risk), or changes in the rates of exchange between currencies (foreign exchange risk). Broker-dealers may have risk committees, which establish trading limits in order to manage market risk.

6.20 *Litigation risk*. Litigation risk refers to the risk of losses resulting from lawsuits and the cost of defending against such claims. Lawsuits can arise from the various aspects of the broker-dealer's business. Areas of particular concern include underwriting activities, employment matters, and the maintenance of customer accounts. Broker-dealers can help mitigate litigation risk in many ways, including the following:

- Establishing policies regarding a code of professional conduct, the employer's responsibilities, and due diligence and establishing a system to monitor compliance with such policies
- Establishing a compliance function to review the activities of the sales departments and branch office operations

6.21 *Regulatory risk*. Regulatory risk refers to potential losses that might arise for failing to comply with applicable statutes, regulations, and rules. Broker-dealers operate in a highly regulated industry that requires close attention to compliance matters. Not only may such matters affect a broker-dealer's reputation and growth, but noncompliance may also lead to fines, limitation on activities the broker-dealer is allowed to carry out, or even the suspension or revocation of the broker-dealer's registration.

6.22 *Liquidity and funding risk*. Liquidity and funding risk refers to a broker-dealer's ability to secure funding to satisfy its settlement or other obligations. Market and other factors may impact the broker-dealer's ability to secure funding to satisfy their obligations. Understanding and evaluating this issue, especially in a highly competitive or unstable market, is important in assessing the going-concern assumption.

Understanding Risk Assessment

6.23 The auditor should obtain sufficient knowledge of the broker-dealer's risk assessment process to understand how management considers risks relevant to financial reporting objectives and decides about actions to address those risks. In evaluating the design and implementation of the entity's risk assessment process, the auditor should consider how management identifies business risks relevant to financial reporting, estimates the significance of the risks, assesses the likelihood of their occurrence, and decides upon actions to manage them. The use of IT may be an important part of a broker-dealer's

risk assessment process, including providing timely information to facilitate the identification and management of risks.

6.24 A broker-dealer's risk assessment differs from the auditor's consideration of audit risk in a financial statement audit. The purpose of a broker-dealer's risk assessment is to identify, analyze, and manage risks that affect the broker-dealer's objectives. In a financial statement audit, the auditor assesses risks to evaluate the likelihood that material misstatements could occur in the financial statements.

Information and Communication System

6.25 An information system consists of infrastructure (physical and hardware components), software, people, procedures (manual and automated), and data. Infrastructure and software will be absent, or have less significance, in systems that are exclusively or primarily manual. Many information systems, particularly within the financial services industry, make extensive use of IT. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether IT or manual, and records established to initiate, authorize, record, process, and report the broker-dealer's transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. Transactions may be initiated manually or automatically by programmed procedures. Authorization includes the process of approving transactions by the appropriate level of management. Recording includes identifying and capturing the relevant information for transactions or events. Processing includes functions such as edit and validation, calculation, measurement, valuation, summarization, and reconciliation, whether performed by IT or manual procedures. Reporting relates to the preparation of financial reports as well as other information, in electronic or printed format, that the entity uses in measuring and reviewing the entity's financial performance and in other functions. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the broker-dealer's activities and to prepare reliable financial reports. Accordingly, an information system encompasses methods and records that

- identify and record all valid transactions.
- describe, on a timely basis, the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- present properly the transactions and related disclosures in the financial statements.

6.26 Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the broker-dealer. Open communication channels help ensure that exceptions are reported and acted on. Communication can take the form of policy manuals, accounting

and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

Understanding the Broker-Dealer's Information and Communication System

6.27 The auditor should obtain sufficient knowledge of the broker-dealer's information system,[3] including the related business processes relevant to financial reporting, to understand the following:

- The classes of transactions in the broker-dealer's operations that are significant to the financial statements
- The procedures, within both automated and manual systems, by which transactions are initiated, authorized, recorded, processed, and reported from their occurrence to their inclusion in the financial statements
- The related accounting records, whether electronic or manual, supporting information, and specific accounts in the financial statements involved in initiating, recording, processing and reporting transactions
- How the information system captures other events and conditions that are significant to the financial statements
- The financial reporting process used to prepare the broker-dealer's financial statements, including significant accounting estimates and disclosures

6.28 When IT is used to initiate, record, process, or report transactions or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for significant accounts or may be critical to the effective functioning of manual controls that depend on IT.

6.29 In obtaining an understanding of the financial reporting process (including the closing process), the auditor should obtain an understanding of the automated and manual procedures an entity uses to prepare financial statements and related disclosures, and how misstatements may occur. Such procedures include

- the procedures used to enter transaction totals into the general ledger.
- the procedures used to initiate, authorize, record, and process journal entries in the general ledger.
- other procedures used to record recurring and nonrecurring adjustments to the financial statements.
- the procedures to combine and consolidate general ledger data.
- the procedures to prepare financial statements and disclosures.

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[3] Evaluation of the process for ensuring that important static reference data is adequately controlled is a consideration for automated systems.

6.30 The auditor also should obtain sufficient knowledge of the means the broker-dealer uses to communicate financial reporting roles and responsibilities and significant matters relating to financial reporting.

Control Activities

6.31 Control activities are the policies and procedures that help ensure that management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the broker-dealer's objectives. Control activities, whether automated or manual, have various objectives and are applied at various organizational and functional levels. Each control activity is designed to accomplish a specific control objective. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:

- Performance reviews (that is, ensuring that controls are performing as expected)
- Information processing
- Physical controls
- Segregation of duties

6.32 Many of the activities of broker-dealers are unique, and consequently, many of the control activities are also unique. Control activities that may address the following audit concerns include the following:

- *Validity*. Control activities designed to reasonably ensure that recorded transactions include only those that have actually occurred.
- *Completeness*. Control activities designed to reasonably ensure that valid transactions are not omitted entirely from the accounting records.
- *Authorization*. Control activities intended to reasonably ensure that transactions are approved before they are executed and recorded.
- *Valuation (accuracy)*. Control activities designed to reasonably ensure that dollar amounts and values are correctly determined.
- *Classification*. Control activities intended to reasonably ensure that transactions are recorded in the proper accounts, charged and credited to the appropriate customers, and so on.
- *Presentation and disclosure*. Control activities designed to reasonably ensure that the accounting process for a transaction is completely performed and is in conformity with U.S. GAAP.
- *Timing (cutoff)*. Control activities that are designed to reasonably ensure a transaction is accounted for in the proper time period.
- *Regulatory*. Control activities that are designed to reasonably ensure that a transaction complies with the applicable laws and regulations of the SEC and other regulatory bodies.
- *Safeguarding of Assets*. Control activities that are designed to protect against unauthorized acquisition, use or disposal of assets, including customer related assets.

Understanding Control Activities

6.33 The auditor should obtain an understanding of those control activities relevant to the audit. As the auditor obtains an understanding of the other components, he or she is also likely to obtain knowledge about some control activities. For example, in obtaining an understanding of the documents, records, and processing steps in the financial reporting information system that pertain to cash, the auditor is likely to become aware of whether bank accounts are reconciled. The auditor should consider the knowledge about the presence or absence of control activities obtained from the understanding of the other components in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities. An audit does not require an understanding of all the control activities related to each account balance, class of transactions, and disclosure component in the financial statements or to every relevant assertion. Ordinarily, control activities that may be relevant to an audit include those relating to authorization, segregation of duties, safeguarding of assets, and asset accountability, including, for example, reconciliations of the general ledger to the detailed records. The auditor should obtain an understanding of the process of reconciling detail to the general ledger for significant accounts. Also, control activities are relevant to the audit if the auditor is required to evaluate them as discussed in paragraphs .115–.117 of AU section 314.

6.34 In obtaining an understanding of control activities, the auditor's primary consideration is whether, and how, a specific control activity, individually or in combination with others, prevents, or detects and corrects, material misstatements in classes of transactions, account balances, or disclosures. Control activities relevant to the audit are those for which the auditor considers it necessary to obtain an understanding in order to assess risks of material misstatement at the assertion level and to design and perform further audit procedures responsive to the assessed risks. The auditor's emphasis is on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that material misstatements are more likely to occur. When multiple control activities achieve the same objective, it may be unnecessary to obtain an understanding of each of the control activities related to such objective.

6.35 For purposes of evaluating the effectiveness of internal control over financial reporting in accordance with PCAOB standards, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit. (Paragraph .42 of AU-P section 319).

6.36 The auditor should obtain an understanding of how IT affects control activities that are relevant to planning the audit. Some broker-dealers and auditors may view the IT control activities in terms of application controls and general controls. Application controls apply to the processing of individual applications. Accordingly, application controls relate to the use of IT to initiate, authorize, record, process, and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed.

6.37 Application controls may be performed by IT or by individuals. When application controls are performed by people interacting with IT, they may be referred to as user controls. The effectiveness of user controls, such as reviews

of computer-produced exception reports or other information produced by IT, may depend on the accuracy of the information produced.

6.38 General controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. General controls commonly include controls over data center and network operations; system software acquisition and maintenance; access security; and application system acquisition, development, and maintenance.

6.39 The use of IT affects the way that control activities are implemented. For example, when IT is used in an information system, segregation of duties often is achieved by implementing security controls.

Monitoring

6.40 Monitoring is a process that assesses the quality of an entity's internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions. The frequency with which controls are assessed depends on the significance of the risk being controlled, and the importance of a particular control in reducing the risk. Higher priority risks generally will require more frequent assessment. Similarly, those controls most critical to reducing a given risk will tend to be assessed more often.

6.41 Monitoring of controls is accomplished through ongoing monitoring activities, through separate evaluations, or a combination of the two. Ongoing monitoring activities are built into the normal recurring activities of a broker-dealer, and include regular management and supervisory activities, comparisons, reconciliations, and other actions personnel take in performing their duties. Managers at divisional and corporate levels are in touch with operations and may question reports that differ significantly from their knowledge of operations. Usually, some combination of ongoing monitoring and separate evaluations will together ensure that internal control maintains its effectiveness over time.

6.42 In many broker-dealers, internal auditors or personnel performing similar functions contribute to the monitoring of broker-dealer's activities through separate evaluations. They regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the design and operation of internal control. They communicate information about strengths and weaknesses and recommendations for improving internal control.

6.43 Monitoring activities may include using information from communications from external parties. Customers implicitly corroborate transaction data by paying their amount owed or complaining about their charges. In addition, regulators may communicate with the broker-dealer concerning matters that affect the functioning of internal control, for example, communications concerning examinations by self-regulatory organizations. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

6.44 In many entities, much of the information used in monitoring may be produced by the entity's information system. If management assumes that

data used for monitoring are accurate without having a basis for that assumption, errors may exist in the information, potentially leading management to incorrect conclusions from its monitoring activities.

Understanding Monitoring Activities

6.45 The auditor should obtain an understanding of the major types of activities the broker-dealer uses to monitor internal control over financial reporting, including the source of the information related to those activities, and how those activities are used to initiate corrective action. Paragraphs .04–.08 of AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1), provides requirements and guidance related to obtaining an understanding in situations where the entity has an internal audit function.

Broker-Dealer Control and Monitoring Activities

6.46 Control and monitoring activities may be present in the functions of a broker-dealer. Management uses such activities to mitigate business risk. This guide discusses only those control and monitoring activities that are unique to broker-dealers. The absence of any of these specific control activities is not indicative of a deficiency in internal control; however, a deficiency in internal control may exist if the overall control objective is not met.

6.47 The discussion of control and monitoring activities in this part of the chapter is primarily from management's perspective and is intended to provide the auditor with an overview of the types of desirable controls. Management of all broker-dealers have a responsibility to establish and maintain adequate internal control over financial reporting and to comply with specific rules addressing financial responsibility and recordkeeping.[4] Management of an issuer is required by Section 404(a) of the Sarbanes-Oxley Act of 2002 to assess the effectiveness of the company's internal control over financial reporting and to include in the company's annual report to shareholders management's conclusion as a result of that assessment about whether the company's internal control is effective. This guide is not intended to provide guidance to management of issuer broker-dealers on how to comply with the requirements of the Sarbanes-Oxley Act. However, the "SEC Requirements for Management's Report on Internal Control Over Financial Reporting" section at the end of this chapter provides some general information on internal control reporting requirements established by the Sarbanes-Oxley Act.

6.48 Security transactions may be processed, recorded, and monitored by different departments within the broker-dealer. Even though this discussion addresses specific broker-dealer control and monitoring activities, the presentation is general in nature and does not necessarily reflect the actual operations or departments of every broker-dealer. Control and monitoring activities performed by persons with appropriate segregation of duties provides the strongest control environment.

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[4] In February 2009, the Committee of Sponsoring Organizations of the Treadway Commission announced it has released *Guidance on Monitoring Internal Control Systems*. For further information, visit www.coso.org.

Sales and Compliance

6.49 *New accounts*. Control and monitoring activities for opening and maintaining new accounts are essential for broker-dealers. The opening of new accounts is primarily the responsibility of customer service centers and branch offices. Control and monitoring activities are designed to ensure that recorded transactions are valid, complete, and properly authorized. Broker-dealers follow various activities (some of which are required by regulatory authorities), such as the following:

- Have new accounts approved by appropriate personnel and ensure that the account file contains documentation concerning the essential facts pertaining to each customer. For instance, if the customer is a corporation, the file indicates that the person from whom the orders are accepted is duly authorized by the corporation to act on its behalf. Rules requiring such documentation, as well as related account supervision activities, are referred to as the "know your customer" rules. Special documentation may also be required for other accounts, such as for all customers who wish to trade options or customers who are nonresident aliens.
- Have customer files contain signed copies of IRS Form W-9, "Request for Taxpayer Identification Number and Certification," and, for non-U.S. citizens, IRS Form W-8, "Certificate of Foreign Status."
- Have margin customers sign agreements, referred to as *hypothecation agreements*, that authorize the broker-dealer to use customers' securities that are not fully paid for. Broker-dealers may finance unpaid balances by borrowing money from banks or other broker-dealers, and use customer securities as collateral to the extent permissible.
- Require all accounts in the name of the customer, unless the broker-dealer has received a written statement signed by the customer attesting to his or her ownership of an account in any other name, symbol, or number.
- Mail letters to customers, requesting confirmation after being notified of changes in addresses. Some broker-dealers mail confirmation requests to the customers' last known and current addresses.
- Mail or electronically transmit, as appropriate, customer statements periodically (at least quarterly, or monthly if there is any activity), unless a customer has requested in writing—and a designated official has approved the request—that the statements not be mailed.
- Require written authorization from each customer for whom the broker-dealer carries a discretionary account, receiving the approval (from a designated person who does not exercise discretionary authority) for every trade in the discretionary account, and mail an advice to the discretionary account customer on the date each trade is executed.
- Identify the accounts of partners, officers, and employees and their known relatives so that transactions in such accounts can be reviewed by designated personnel.

- Obtain written approval from another broker-dealer for opening an account of an employee of that broker-dealer.
- Ensure policies and procedures exist and function to comply with the requirements of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the Patriot Act).
- Accurately capture all unique customer data attributes in the broker-dealer's client reference data master files, which will serve as the source for key downstream processing.

6.50 *Order entry*. The primary objectives of the order department are to ensure that all authorized orders are directed to the proper marketplace, executed, and accurately recorded. The auditor may identify and test control and monitoring activities over customer orders to purchase and sell securities because of the volume of accounting information generated from customer order forms. Customer orders generate accounting entries that affect the following financial statement accounts:

- Receivables from and payables to customers
- Firm inventory
- Receivables from and payables to other broker-dealers and clearing organizations
- Commission income and expense
- Interest income and expense
- Cash

6.51 Some of the control and monitoring activities typically associated with the order department include

- assigning a number to orders when placed and accounting for all order numbers.
- reviewing, by supervisory personnel, the open order file.
- comparing trade data recorded on the customer confirmation with the order form prepared by the order department and registered representative before mailing it to the customer.
- requiring that the execution price of an order be confirmed by the order department to the registered representative, and by the registered representative to the customer, shortly after placing the order. Lack of confirmation of execution usually initiates inquiry by the registered representative or customer.
- including a check digit in the customer account number on order forms.
- segregating and not processing orders lacking required information, such as an invalid contra broker-dealer number.
- verifying completed order forms.
- not processing limit orders if the execution price is not within predetermined market limits.
- using order forms that provide for the entry of all relevant information about an order to be processed.

- time-stamping orders when they are placed, when they are transmitted to exchanges or trading rooms, and upon notice of execution. Disputes regarding prices can be resolved based on the time the order was placed and executed.
- requiring orders, other than those automatically executed, to be initiated by a registered representative, placed by the order desk, executed by a trader, and confirmed by a floor clerk.
- reviewing exception reports to resolve quantity and price differences.

6.52 *Sales compliance*. The compliance department is responsible for ensuring that the broker-dealer's sales activities are conducted in accordance with applicable laws and regulations. Some of the control and monitoring activities typically associated with and in connection with regulatory rules requiring adequate supervision of the sales compliance function include the following:

- Monitoring and reviewing transactions in customer accounts for suitability, particularly with respect to discretionary accounts
- Documenting and investigating customer complaints
- Requiring sales representatives to be registered in accordance with applicable regulations
- Monitoring and reviewing transactions in employee accounts
- Requiring a cash transaction reporting form to be completed for all receipts of funds, in conformity with the Bank Secrecy Act
- Reviewing proprietary transactions to identify transactions that may violate prohibitions on insider trading or represent manipulative and deceptive practices.
- Monitoring and actively reviewing closed accounts or inactive accounts
- Generating and then reviewing exception reports that highlight unusual activity
- Reviewing sales and advertising literature to ensure compliance with federal and state securities laws, as well as with various regulations of self-regulatory bodies
- Reviewing IPOs to customers to ensure that the securities offered are registered in accordance with the Securities Act of 1933 and in accordance with state Blue-Sky laws

Clearance

6.53 *Purchases and sales*. The purchase and sales (P&S) department processes customer and proprietary orders and is responsible for the following:

- Recording purchases and sales transactions if that is not done automatically through the order entry process
- Preparing confirmations of securities transactions
- Comparing transactions with other broker-dealers and clearing organizations, and computing commissions, taxes, and other fees

6.54 Some of the control and monitoring activities typically associated with the P&S department include the following:

- Compare the total number of orders entered to the total number of orders on the trade date blotter and reconcile any differences (for instance, canceled trades, limit orders not executed, and rejects).
- Recap daily the adjustments between trade date blotters (such as T/D+1, T/D+2, T/D+3) and use them to reconcile those blotters.
- Trace all totals on the settlement blotters to the general ledger.
- Prohibit P&S personnel from obtaining access to customer accounts, stock records, margin records, the cashier's department, and the mailing department.
- Compare order tickets, on a test basis, to entries on the trade date blotter, and recomputing commissions, taxes, and other fees.
- Compare all transactions cleared through clearing organizations with clearing organization contract sheets, or electronically through IT interfaces (including electronic communications networks), and comparing all broker-to-broker transactions with confirmations received from the contra broker-dealer.
- Balance principal transactions with customers internally against the firm trading accounts with exceptions promptly entered into the suspense file and investigated.
- Balance presettlement customer and streetside transactions daily, to ensure that balance entries are posted to the general ledger and securities record.
- Periodically (preferably daily) review, age, and report to appropriate officials concerning open P&S suspense items because suspended trades represent potential fails, "don't knows," unknown inventory positions, or financing costs.
- Agree amounts and account distributions on the settlement blotter to general ledger entries.
- Summarize on exception reports and actively review "as of" transactions and "canceled and corrected" transactions.
- Mail trade confirmations to customers generally before settlement date and reporting any misstatements noted by customers.

Securities Settlement

6.55 *Receive and deliver*. All receipts and deliveries of securities and money are handled by the receive-and-deliver section of the cashier's department. Some of the control and monitoring activities typically associated with the receive-and-deliver function include the following:

- Receiving or delivering securities only if they are supported by written instructions prepared by another department or workstation
- Electronic imaging of securities received and delivered to resolve any differences between broker-dealers
- Examining for negotiability (that is, properly endorsed, signed, and guaranteed) and for completeness (that is, coupons and

warrants) securities received before they are placed in the active box or vault

- Recording the certificate numbers of securities received
- Authorizing certain designated employees to execute or guarantee assignments
- Maintaining control over the facsimile signature devices used
- Designating an employee who does not handle securities or cash to determine that payment is received when securities are delivered against payment
- Bonding all employees who handle securities and money
- Balancing daily movements of securities, and assigning responsibility for the clearance of out-of-balance positions to specific individuals who have no other duties related to any other aspects of securities processing
- Investigating and resolving securities positions (and related ledger amounts) in suspense accounts on a timely basis
- Ensuring that due bills for dividends are identified and recorded with the receipt or delivery of securities
- Periodically comparing the details of fails-to-receive and fails-to-deliver with the stock record in accordance with SEC Rule 17a-13, and agreeing the respective amounts receivable or payable to the related general ledger control accounts
- Maintaining aging schedules of fail-to-receive and fail-to-deliver transactions currently, following up on aged fail transactions, initiating buy-ins in accordance with various regulatory rules, and analyzing aged fails for regulatory purposes
- Periodically reviewing operations suspense items to determine the propriety of receivables or payables carried in the account
- Comparing suspense items with underlying trade tickets or other records, and reviewing the propriety of the subsequent clearance of suspense items

6.56 *Extension of credit*. The margin department, also called the credit department, monitors the extension of credit to customers. Some of the control and monitoring activities over transactions with customers that are typically associated with the margin department include the following:

- Establishing procedures to ensure compliance with the requirements of Federal Reserve Regulation T (Regulation T) including cash, margin, and other accounts, as well as maintenance margin (NYSE Rule 431)[†] requirements
- Implementing a system designed to prevent violations of Regulation T and similar regulations addressing the extension and maintenance of credit, including the prompt issuance of Regulation T calls and maintenance calls, and prompt follow-up action in the event that calls are not met

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[†] Financial Industry Regulatory Authority (FINRA) Rule 4210, *Margin Requirements*, was introduced with the filing of SR-FINRA-2010-024 and has been approved by the SEC. The effective date has not yet been determined. Upon the effective date of the rule, New York Stock Exchange Rule 431 will no longer be applicable.

- Implementing a system to have "house" margin requirements that are higher than those established by regulatory authorities, if it is considered necessary for the protection of the broker-dealer
- Performing credit investigations before transacting business with a customer and before establishing credit limits
- Obtaining signed margin agreements before trading in a margin account can occur
- Disbursing cash and delivering securities only upon written authorization of the appropriate personnel
- Requiring the authorization of margin department personnel before paying funds or withdrawing securities from customers' accounts
- Prohibiting margin clerks from initiating entries to customer accounts and from having contact with customers' securities, remittances, or disbursements
- Assigning responsibility for monitoring customer accounts to specific employees, who are rotated onto other duties periodically
- Reviewing margin records periodically (by an employee who has no duties in connection with them) to determine that the minimum margin requirements of the firm are being maintained
- Promptly reporting to management on customers' undermargined accounts and unsecured or partly secured accounts, for purposes of evaluation concerning collectability
- Delegating duties appropriately and rotating the duties of personnel in key control areas
- Accepting securities received from customers that are registered in a name other than the customer's only if proof of ownership is provided
- Permitting only designated employees to make entries to customer accounts, and requiring that two employees approve changes to customer account files. Limit the types of transactions (such as cash receipts, cash disbursements, securities receipts and deliveries, or adjustments) that an employee can initiate
- Establishing procedures to ensure compliance with the requirements of SEC Rules 400–406 and CFTC Rules 41.42–41.49 governing customer margin for transactions in security futures
- Reviewing securities underlying receivables and payables regularly concerning their valuation

Custody

6.57 *Cashiering*. The cashiering department is responsible for the custody, safekeeping, and segregation of securities. Some of the control and monitoring activities typically associated with the custody function include

- maintaining securities that are on the premises in a fireproof vault.
- keeping securities that are not needed in daily operations at depositories.

- maintaining physical controls over securities on hand by restricting access to areas containing securities to authorized employees, and by keeping the cage and vault doors always locked.
- using dual controls over access to securities.
- limiting the number of employees who have access to physical securities.
- noting, in the records of the broker-dealer, customers' fully paid and excess-margin securities as securities required to be in its physical possession or control in accordance with SEC Rule 15c3-3; maintaining records of customers' fully paid and excess-margin securities not in the broker-dealer's possession or control, determining the location of such securities, and initiating action to bring them into possession or control within the time frames set forth in the rule.
- periodically imaging electronically securities on hand for use in researching any misstatements.
- conducting surprise counts of securities on hand.
- confirming securities, counting securities, or both, once each calendar quarter and comparing the results to the books and records, as required under SEC Rule 17a-13, "Quarterly Securities Examinations." SEC Rule 17a-13 requires that certain broker-dealers, at least once in each calendar quarter, physically examine and count all securities held and account for all other securities that are subject to the broker-dealer's control or direction and are not in its physical possession. The counting and verification of securities is required to be performed by or supervised by personnel that do not have daily responsibility for the securities.
- agreeing results of security counts, and verifications to the stock record, with any differences noted in accordance with the Rule 17a-13 and followed to a conclusion.
- agreeing daily, and reconciling at least monthly, the details of transactions for accounts carried by other broker-dealers (such as omnibus accounts), and resolving any differences.
- daily reconciling of the securities held at depositories to the stock record.
- balancing, on a daily basis, customer accounts with the stock record and general ledger control accounts, as well as with margin department records.
- identifying and segregating worthless and restricted securities.

6.58 *Securities transfer*. The transfer department is responsible for the transfer of ownership and the registration and reissuance of securities. The following are some of the control and monitoring activities typically associated with the transfer department:

- Recording in a memo field on the stock record transfer instructions
- Matching securities received back from the transfer agent against open transfer instructions

- Maintaining and reporting, for management and regulatory purposes, the aging of open transfer items
- Periodically confirming, with the transfer agent, aged open transfer items

Dividends, Interest, and Reorganization

6.59 *Dividends and interest*. The dividend department normally monitors dividends declared by corporations, monitors the collection (and payment, if the broker-dealer is short) of dividends, records interest and dividends on securities owned by the firm or its customers, and credits customer and firm accounts with their dividends and interest. The following are some of the control and monitoring activities typically associated with the processing of dividends and interest:

- Receiving information regarding dividend declarations and other corporate actions electronically from independent dividend-reporting services
- Manually reviewing input dividend information separately
- Obtaining information regarding bond interest coupon dates when new issues are recorded on the securities master file
- Automatically creating, on the record date from an extract of the stock record (commonly referred to as a *take-off sheet*), a dividend file that identifies all long and short security positions in each issue for which a dividend has been declared
- Crediting, through an automated process on the payment date, all entries to customer, noncustomer, and processing accounts
- Recording in the suspense account and having the dividend department investigate differences between money received and the receivable amount or between money paid and the payable amount
- Following up with paying agents or depositories holding the firm's and its customers' securities in street name for payments
- Routinely aging receivables and payables and long and short stock dividends for exposure and for regulatory and escheatment purposes, and reporting them to management

6.60 *Reorganizations*. The reorganization department is responsible for the processing of securities involving corporate reorganizations, consolidations, subscriptions, and exchanges. Some of the control and monitoring activities typically associated with reorganization departments include

- receiving information regarding pending reorganization transactions electronically from independent reporting services.
- manually reviewing input reorganization information separately.
- controlling physical movements of securities subject to pending reorganizations by processing them through the appropriate reorganization accounts.
- balancing all reorganization transactions on a security-by-security basis.

- periodically recording and confirming money receivable or securities at agents with any differences entered into a suspense account and investigated.

Mortgage-Backed Securities

6.61 Broker-dealers often obtain and sell mortgage-backed securities. Some of the control and monitoring activities that are typically associated with such securities include

- establishing and monitoring a standardized strategy for allocating to be announced securities (TBAs) to specified pools.
- analyzing and monitoring securities received in incoming pools.
- properly recording unallocated TBAs as fails.
- ensuring that the allocation of TBAs to pools is efficient, adequately validated, and properly recorded.
- ensuring that complete and correct factor updates are received on a timely basis.
- obtaining principal and interest information (including factors) from external sources (especially for derivatives) and ensuring that the validated information is updated on the appropriate systems on a timely basis.

Principal Transactions

6.62 *Firm trading*. Many broker-dealers buy and sell securities and OTC derivatives in their capacity as dealers and as part of various positioning strategies that attempt to generate profits by anticipating future market movements. These dealer and positioning strategies are collectively referred to as *firm trading*. Given the volatility of the financial markets, proper control and monitoring activities over firm trading activities are critical. Some of the control and monitoring activities that are typically associated with firm trading generally include

- establishing overall position limits, as well as separate limits for each trader and product.
- monitoring positions daily and daily monitoring trading gains and losses by each trader on a trade date basis.
- daily reconciling trading desk records, which are maintained on a trade date basis, to the accounting department records.
- daily marking to market firm trading positions with prices obtained from independent pricing sources.
- reviewing all trader-determined valuations or overridden valuations.
- assessing the liquidity of firm positions and evaluating fair value in inactive markets.
- management review of reports of all aged positions.
- management review of reports of position concentrations.
- sending trade confirmations to each counterparty.
- recording traders' phone conversations with counterparties.

- reviewing daily the automated comparison of settled positions on the firm inventory system versus positions on the stock record.
- comparing trade tickets to the daily transaction information recorded on the firm's books and records.
- time-stamping or electronic monitoring of trade tickets at the time a transaction is received and executed.
- reviewing and verifying all confirmations received from counterparties.
- daily balancing principal transactions conducted with the broker-dealer's customers.
- reviewing pending trades file.
- performing reconciliations between the front-end trading systems and the general ledger.

6.63 *Underwriting*. A broker-dealer may act as a manager, comanager, or syndicate member in the underwriting of public or private offerings of securities. Many of the control and monitoring activities related to firm trading also serve as control and monitoring activities over underwriting activity. Some additional control and monitoring activities typically associated with the underwriting function include

- maintaining the subscription records for the underwriting, and receiving from members of the buying and selling groups reports of orders from their customers, so that the managing underwriter knows at all times the status of the offering.
- separately accounting for the revenue and expenses of the syndicate.
- aging, and separately maintaining on a deal-by-deal basis, amounts receivable or payable that are recorded on the broker-dealer's books pursuant to an underwriting.

OTC Derivative Transactions

6.64 Many broker-dealers enter into derivative transactions in their capacity as dealers and as part of various strategies. Some of the control and monitoring activities that are typically associated with such transactions include

- providing training to staff with respect to systems used to process derivatives, as well as technical updates on the processing of and accounting for new products.
- hiring staff that is experienced with the various types of products processed and ensuring that such staff is supervised by experienced individuals.
- reviewing the systems used to process and account for derivative transactions in order to ensure that they are operating as intended.
- ensuring that the system selected to process derivative transactions is able to handle the current and projected volume of business.

- ensuring that systems or technical personnel are capable of supporting the current system and augmenting features of the system as needed.
- developing a contingency plan in the event that the system breaks down.
- restricting access to the system by using codes and passwords.
- maintaining signed contracts for each derivative transaction, as well as a list of outstanding unsigned contracts.
- reviewing master netting agreements and presentation of netted transactions to ensure that it complies with requirements of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 210, *Balance Sheet*.
- keeping files of correspondence from counterparties regarding payment instructions, amounts to be paid or received, modifications to current contracts, and notifications of early terminations and final payments.
- separating the functions of inputting derivative transactions into the system and of verifying the accuracy of the input.
- separating such functions as monitoring, calculating, and processing of payments and receipts.
- ensuring that the execution of derivative transactions and the monitoring of counterparty credit quality and counterparty exposure limits are performed by separate individuals.
- establishing and maintaining formal policies concerning hedging strategies.[5]
- restricting control and maintenance over legal documentation.
- performing reconciliations between cash disbursements and receipts, systems calculations, and correspondence from counterparties.
- performing the valuation of the derivatives portfolio frequently and obtaining, from reliable sources consistently on each valuation date, the market data used to value the portfolio. Limiting access to models used to value positions and reviewing changes made to those models. The valuation process and the verification of this process is performed by individuals who are independent of the traders.
- analyzing the changes in the portfolio's valuation into the following separate components:
  - — Market fluctuations.
  - — Accretion.
  - — Swap payments/receipts.
  - — Maturations/terminations.
  - — New transactions.
- reconciling traders' estimates of profit and loss to the portfolio valuation system.

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[5] Hedge accounting is permitted only if the requirements of Financial Accounting Standards Board *Accounting Standards Codification* 815, *Derivatives and Hedging*, are met.

Collateralized Financings

6.65 *Stock loan and stock borrow*. These transactions generally result from the need for one broker-dealer to borrow securities for delivery to another broker-dealer or to a customer. At large broker-dealers, the stock loan department has responsibility for entering into such transactions. Some of the control and monitoring activities typically associated with stock loan and stock borrow activity include

- reviewing counterparties for creditworthiness and obtaining master trade agreements and credit approval for counterparties before entering into a stock-loan or stock-borrow transaction.
- establishing transaction limits by counterparty.
- listing those securities in excess of SEC Rule 15c3-3 possession or control requirements as available to be loaned for any given day. Recalling those securities in deficits within the time frames required.
- obtaining physical possession or control of all collateral.
- ensuring that borrows are made in accordance with the requirements of Federal Reserve Regulation T.
- marking to market all collateral daily and, if a deficit (within established guidelines) exists, obtaining additional collateral from the counterparty.
- reconciling the stock-loan and stock-borrow subsidiary ledgers to the stock record (positions) and general ledger (contract amounts) daily. Out-of-balances are recorded as suspense items and researched immediately.
- confirming transactions periodically on a basis that, at a minimum, complies with SEC Rule 17a-13 regarding the quarterly verification of securities.
- listing transactions with unusually high or low rebate terms on an exception report for review by management.
- obtaining and reviewing the Statement on Auditing Standards No. 70 reports[‡] of third party vendors that are involved in securities lending transactions, and addressing all user control considerations and any control issues that are identified.

6.66 *Repos and reverse repos*. Repo agreements are typically entered into to finance positions in government and government-agency securities (see chapter 1, "The Securities Industry," of this guide). Reverse repo agreements are similar to stock borrow transactions, except that reverse repo agreements are generally executed in government and government-agency securities and frequently relate to investment activities, in addition to meeting delivery requirements.

[‡] In April 2010, the Auditing Standards Board issued Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, vol. 1, AT sec. 801). SSAE No. 16 addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user entities when those controls are likely to be relevant to user entities' internal control over financial reporting. It is effective for service audi-tors' reports for periods ending on or after June 15, 2011. Early implementation is permitted. This standard supersedes the guidance for service auditors in AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1).

Control and monitoring activities typically associated with repo and reverse repo agreements include

- reviewing counterparties for creditworthiness and obtaining master trade agreements and credit approval for counterparties before entering into a repo or reverse repo transaction.
- establishing position and credit limits by counterparty.
- reviewing presentation of offsetting transactions (netdown) to ensure that it complies with requirements of FASB ASC 210-20-45.
- obtaining collateral from the counterparty.
- marking to market all collateral daily; if a deficit (within established guidelines) exists, additional collateral may be obtained from the counterparty.
- reconciling the repo and reverse repo subsidiary ledgers to the stock record (positions) and general ledger (contract amounts) daily. Out-of-balances are recorded as suspense items and researched immediately.
- periodically confirming transactions on a basis that, at a minimum, complies with SEC Rule 17a-13 regarding quarterly verification of securities.
- listing transactions with unusually high or low interest terms on an exception report for review by management.

6.67 *Bank loan financing*. A broker-dealer may finance its proprietary or customer activity through collateralized bank loans. Such loans are generally negotiated separately with each bank. Some of the control and monitoring activities typically associated with bank loan financing include the following:

- Ensuring that customer, noncustomer, and firm bank loans are separately maintained and that procedures are in place to prevent commingling of collateral.
- Maintaining separate accounts in the general ledger for each loan, with separate positions being maintained on the stock record for the securities collateralizing each loan.
- Ensuring that securities used to collateralize bank loans for customers are not fully paid or excess-margin securities, because such securities are required to be segregated pursuant to SEC Rule 15c3-3 possession or control requirements.
- Periodically confirming bank loan collateral on a basis that, at a minimum, complies with SEC Rule 17a-13 regarding the quarterly verification of securities.

Report on Internal Control Required by SEC Rule 17a-5(g)(1)

6.68 The auditor has specific requirements under SEC Rule 17a-5(g)(1) related to internal control. The auditor is required to make, and report on, a study of the practices and procedures followed by the broker-dealer, including consideration of control procedures for safeguarding securities. The practices and procedures should be sufficient to provide reasonable assurance that any

material inadequacies existing at the date of the audit would be disclosed. The specific areas to be covered as part of this study include the following:

- The accounting system
- The internal accounting control
- Procedures for safeguarding securities
- The practices and procedures followed by the broker-dealer with respect to the following:
  - — The periodic computations of net capital under SEC Rule 17a-3(a)(11) and the reserve required by SEC Rule 15c3-3(e)
  - — The quarterly securities count rule (SEC Rule 17a-13)
  - — Regulation T requirements for prompt payment of securities
  - — Obtaining and maintaining physical possession or control of securities as required by SEC Rule 15c3-3, including a determination as to the adequacy of the procedures described in the records required to be maintained pursuant to SEC Rule 15c3-3(d)(4)

See chapter 3, "Regulatory Considerations," of this guide for more information on this report and for information on the guidance found in SEC Rule 17a-5(g)(3) relating to material inadequacy. See also appendix C, "Report on Internal Control Required by SEC Rule 17(a)-5(g)(1)."

SEC Requirements for Management's Report on Internal Control Over Financial Reporting[||]

6.69 As directed by Section 404 of the Sarbanes-Oxley Act of 2002, the SEC adopted final rules requiring companies subject to the reporting requirements of the Securities Exchange Act of 1934, other than registered investment companies, to include in their annual reports a report of management on the company's internal control over financial reporting. See the SEC website at www.sec.gov/rules/final/33-8238.htm for the full text of the regulation. This requirement is applicable to public companies. Therefore, privately held broker-dealers would not have to include in their annual reports a management's report on the company's internal control over financial reporting. However, for broker-dealers that are subsidiaries of public companies, auditors may perform additional procedures to be able to report on the consolidated entity's financial statements and internal control in accordance with the SEC requirements and PCAOB standards.

[||] A company that is an *accelerated filer* as defined in Rule 12b-2 under the Securities Exchange Act of 1934 (generally, a U.S. company that has equity market capitalization over $75 million and has filed at least 1 annual report with the commission), is required to comply with the SEC rules regarding Section 404(b) of the Sarbanes-Oxley Act. Nonaccelerated filers have not been subject to this requirement due to a number of deferrals of the requirement. On October 13, 2009, the SEC issued Final Rule 33-9072, which ended the deferral of the auditor attestation requirement for nonaccelerated filers required by Section 404(b) of the Sarbanes-Oxley Act. Under this rule, a nonaccelerated filer would be required to provide the auditor's attestation report on internal control over financial reporting in an annual report filed for fiscal years ending on or after June 15, 2010. However, Section 989G, *Exemption for Non-accelerated Filers*, of the Dodd-Frank Wall Street Reform and Consumer Protection Act signed into law by the President on July 21, 2010, contains a provision that permanently exempts nonaccelerated filers from complying with Section 404(b) of the Sarbanes-Oxley Act.

6.70 The SEC rules clarify that management's assessment and report is limited to *internal control over financial reporting*. Management is not required to consider other aspects of control, such as controls pertaining to operations. The SEC's definition of *internal control* encompasses the Committee of Sponsoring Organizations of the Treadway Commission (COSO) definition but the SEC does not mandate that the entity use COSO as its criteria for evaluating effectiveness.

Annual Reporting Requirements

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

a. *Management's Annual Report on Internal Control Over Financial Reporting*. This report on the company's internal control over financial reporting should contain

   i. a statement of management's responsibilities for establishing and maintaining adequate internal control over financial reporting.

   ii. a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting.

   iii. management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the most recent fiscal year, including a statement concerning whether or not internal control over financial reporting is effective. This discussion should include disclosure of any material weakness in the company's internal control over financial reporting identified by management. Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting.

   iv. a statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.

b. *Attestation Report of the Registered Public Accounting Firm*. This is the registered public accounting firm's attestation report on management's assessment of the company's internal control over financial reporting.

c. *Changes in Internal Control Over Financial Reporting*. This report should disclose any change in the company's internal control over financial reporting that has materially affected or is reasonably likely to materially affect the company's internal control over financial reporting.

Quarterly Reporting Requirements

6.72 The SEC rules also require management to evaluate any change in the entity's internal control that occurred during a fiscal quarter and that

has materially affected, or is reasonably likely to materially affect, the entity's internal control over financial reporting.

6.73 Additionally, management is required to evaluate the effectiveness of the entity's *disclosure controls and procedures* and issue a report concerning their effectiveness on a quarterly basis. With these rules, the SEC introduced a new term, *disclosure controls and procedures*, which is different from *internal controls over financial reporting* and much broader.

6.74 As defined, *disclosure controls and procedures* encompass the controls over all material financial *and nonfinancial information* in the Securities Exchange Act of 1934 reports. Information that would fall under this definition that would *not* be part of an entity's internal control over financial reporting might include the signing of a significant contract, changes in a strategic relationship, management compensation, or legal proceedings.

Chapter 7

Accounting Standards

7.01 U.S. generally accepted accounting principles (GAAP) apply to broker-dealers in the same manner as they apply to other industries; however, certain activities of broker-dealers' operations are unique. It is the purpose of this chapter to identify and discuss the accounting treatment for certain of those unique activities that are engaged in by broker-dealers. New broker-dealer activities may develop that will require accounting guidance to reflect their economic substance. The accounting principles that apply to the specific activities addressed in this chapter can be applied to other activities that are similar to those discussed. Broker-dealers also prepare regulatory reports and supplemental information in addition to financial statements. Accounting and reporting requirements under U.S. GAAP may differ from broker-dealer regulatory accounting and reporting requirements stipulated by the Securities and Exchange Commission (SEC) and other regulatory organizations (see chapter 3, "Regulatory Considerations," in this guide). In addition, the financial reporting practices and the recording of transactions discussed in this chapter may differ significantly from the tax basis of reporting.

Accounting Model

7.02 A broker-dealer accounts for inventory and derivative positions (such as futures, forwards, swaps, and options) at fair value. Most other assets, such as fixed assets, accounts receivable, securities borrowed, securities purchased under agreements to resell (known as resale or reverse repurchase agreements or reverse repos), and exchange memberships owned, are reported at historical cost, at contract, or the fair value of collateral to be returned. Obligations for short inventory positions are reported at fair value.

7.03 Per Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 940-20-30-2, liabilities related to broker-dealer operations, such as fails-to-receive and securities sold under agreements to repurchase (known as repurchase agreements or repos), are recorded at contract amounts or the fair value of collateral to be returned.

7.04 Fair value is measured by management using the guidance provided in FASB ASC 820, *Fair Value Measurements and Disclosures*, and is usually determined for accounting purposes as of the end of the entity's business day in the principal location of the broker-dealer entity issuing financial statements.

7.05 FASB ASC 820 defines *fair value*, establishes a framework for measuring fair value, and requires certain disclosures about fair value measurements. The following paragraphs summarize FASB ASC 820 but are not intended as a substitute for reviewing FASB ASC 820 in its entirety.

Definition of Fair Value

7.06 FASB ASC 820-10-20 defines *fair value* as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." FASB ASC 820-10-35-5 states that a fair value measurement assumes that the transaction to sell the asset or transfer the liability either occurs in the principal market for the

asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The FASB ASC glossary defines the *principal market* as the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The principal market (and thus, market participants) should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities.

7.07 FASB ASC 820-10-35-3 provides that the hypothetical transaction to sell the asset or transfer the liability is considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the objective of a fair value measurement 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). Conceptually, entry prices and exit prices are different. However, FASB ASC 820-10-30-3 explains that, in many cases, at initial recognition a transaction price (entry price) will equal the exit price and, therefore, will represent the fair value of the asset or liability at initial recognition. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, the reporting entity should consider facts specific to the transaction and the asset or liability.

7.08 Paragraphs 7–8 of FASB ASC 820-10-35 provide that the price should not be adjusted for transaction costs. If location is an attribute of the asset or liability (as might be the case for a commodity), the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability should be adjusted for the costs, if any, that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market.

Application to Assets

7.09 FASB ASC 820-10-35-10 provides that a fair value measurement of an asset assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. Highest and best use is determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different.

7.10 FASB ASC 820-10-35-10 provides that the highest and best use for an asset is established by one of two valuation premises: value in-use or value in-exchange. The highest and best use of the asset is in-use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use). For example, value in-use might be appropriate for certain nonfinancial assets. The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis. For example, value in-exchange might be appropriate for a financial asset. According to paragraphs 12–13 of FASB ASC 820-10-35, an asset's value in-use should be based on the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets as a group and that those other assets would be available to market participants. An asset's value in-exchange is determined based on the price that would be received in a current transaction to sell the asset standalone.

Application to Liabilities*

7.11 According to FASB ASC 820-10-35-16, a fair value measurement assumes that both (1) the liability is transferred to a market participant at the measurement date (the liability to the counterparty continues; it is not settled), and (2) the nonperformance risk relating to that liability is the same before and after its transfer. Paragraphs 17–18 of FASB ASC 820-10-35 provide that a fair value measurement of a liability should reflect 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.

Valuation Techniques

7.12 Paragraphs 24–35 of FASB ASC 820-10-35 describe the valuation techniques that should be used to measure fair value. Valuation techniques consistent with the market approach, income approach, or cost approach should be used to measure fair value, as follows:

- The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. Valuation techniques consistent with the market approach include matrix pricing and often use market multiples derived from a set of comparables.
- The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Valuation techniques consistent with the income approach include present value techniques, option-pricing models, and the multiperiod excess earnings method.
- The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as *current replacement cost*). Fair value is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

7.13 According to FASB ASC 820-10-35-24, valuation techniques that are appropriate in the circumstances and for which sufficient data are available should be used to measure fair value. In some cases, a single valuation technique will be appropriate (for example, when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (for example, as might be the case when valuing a reporting unit), and the respective indications of fair value should be evaluated and weighted, as appropriate, considering the

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* In August 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2009-05, *Fair Value Measurements and Disclosures (Topic 820)—Measuring Liabilities at Fair Value*. ASU No. 2009-05 provides amendments to FASB *Accounting Standards Codification* (ASC) 820-10 for the fair value measurement of liabilities and includes specific guidance on valuation techniques and the related fair valuation hierarchy for liabilities. The amendments are effective for the first reporting period (including interim periods) beginning after its issuance. Readers should consult the full text of ASU No. 2009-05 for further information. This amended guidance is located in FASB ASC 820-10-35 and FASB ASC 820-10-55.

reasonableness of the range indicated by those results. Example 3 (paragraphs 35–41) of FASB ASC 820-10-55 illustrates the use of multiple valuation techniques. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

7.14 Paragraphs 25–26 of FASB ASC 820-10-35 explain that valuation techniques used to measure fair value should be consistently applied. However, a change in a valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. Such a change would be accounted for as a change in accounting estimate in accordance with the provisions of FASB ASC 250, *Accounting Changes and Error Corrections*.

Present Value Techniques

7.15 Paragraphs 4–20 of FASB ASC 820-10-55 provide guidance on present value techniques. Those paragraphs neither prescribe the use of one specific present value technique nor limit the use of present value techniques to the three techniques discussed therein. They say that a fair value measurement of an asset or liability using present value techniques should capture the following elements from the perspective of market participants as of the measurement date:

- An estimate of future cash flows
- Expectations about possible variations in the amount or timing (or both) of the cash flows
- The time value of money, the price for bearing the uncertainty inherent in the cash flows (risk premium)
- Other case-specific factors that would be considered by market participants
- In the case of a liability, the nonperformance risk relating to that liability, including the reporting entity's (obligor's) own credit risk

7.16 FASB ASC 820-10-55-6 provides the general principles that govern any present value technique, as follows:

- Cash flows and discount rates should reflect assumptions that market participants would use in pricing the asset or liability.
- Cash flows and discount rates should consider only factors attributed to the asset (or liability) being measured.
- To avoid double counting or omitting the effects of risk factors, discount rates should reflect assumptions that are consistent with those inherent in the cash flows. For example, a discount rate that reflects expectations about future defaults is appropriate if using the contractual cash flows of a loan, but is not appropriate if the cash flows themselves are adjusted to reflect possible defaults.
- Assumptions about cash flows and discount rates should be internally consistent. For example, nominal cash flows (that include the effects of inflation) should be discounted at a rate that includes the effects of inflation.
- Discount rates should be consistent with the underlying economic factors of the currency in which the cash flows are denominated.

7.17 FASB ASC 820-10-55-9 describes how present value techniques differ in how they adjust for risk and in the type of cash flows they use. For example, the discount rate adjustment technique (also called the traditional present value technique) uses a risk-adjusted discount rate and contractual, promised, or most likely cash flows. In contrast, method 1 of the expected present value techniques uses a risk-free rate and risk-adjusted expected cash flows. Method 2 of the expected present value technique uses a risk-adjusted discount rate (which is different from the rate used in the discount rate adjustment technique) and expected cash flows. In the expected present value technique, the probability-weighted average of all possible cash flows is referred to as the *expected cash flows*. The traditional present value technique and two methods of expected present value techniques are discussed more fully in FASB ASC 820-10-55.

7.18 This guide includes guidance about measuring assets and liabilities using traditional present value techniques. That guidance is not intended to suggest that the income approach is the only one of the three approaches that is appropriate in the circumstances, nor is it intended to suggest that the traditional present value technique described in the guide is preferred over other present value techniques.

The Fair Value Hierarchy

7.19 FASB ASC 820-10-35-51D emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, as stated by FASB ASC 820-10-35-9, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability (referred to as inputs). Paragraphs 37–58 of FASB ASC 820-10-35 establish a fair value hierarchy that distinguishes between (*a*) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (*b*) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). Valuation techniques used to measure fair value should maximize the use of observable inputs and minimize the use of unobservable inputs.

7.20 The fair value hierarchy in FASB ASC 820-10-35 prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The three levels are as follows:

- Paragraphs 40–41 of FASB ASC 820-10-35 state that 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. An *active market*, as defined by FASB ASC glossary, is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and should be used to measure fair value whenever available, with certain exceptions.[†] FASB ASC 820-10-35-44 provides

[†] FASB ASC 820-10-35 paragraphs 16D and 42–43 discuss situations in which a quoted price in an active market may not provide the most reliable evidence of fair value.

guidance on how the quoted price should not be adjusted because of the size of the position relative to trading volume (blockage factor), but rather would be measured within level 1 as the product of the quoted price for the individual instrument times the quantity held.

- Paragraphs 47–51 of FASB ASC 820-10-35 explain that level 2 inputs are inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a level 2 input must be observable for substantially the full term of the asset or liability. Adjustments to level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition and location of the asset or liability, the extent to which the inputs relate to items that are comparable to the asset or liability, and the volume and level of activity in the markets within which the inputs are observed. As discussed in paragraph 48 of FASB ASC 820-10-35, level 2 inputs include

  — quoted prices for similar assets or liabilities in active markets.

  — quoted prices for identical or similar assets or liabilities in markets that are not active.

  — inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates).

  — inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

  According to FASB ASC 820-10-35-51, an adjustment that is significant to the fair value measurement in its entirety might render the measurement a level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall.

- As discussed in paragraphs 52–55 of FASB ASC 820-10-35, level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. Unobservable inputs should be developed based on the best information available in the circumstances, which might include the entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. Unobservable inputs should reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). Assumptions about risk include the risk inherent in the inputs to the valuation technique. 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. The reporting entity should not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the entity's own data used to develop unobservable inputs should be adjusted if information is readily available without undue cost and effort that indicates that market participants would use different assumptions. FASB ASC 820-10-55-22 provides examples of level 3 inputs for particular assets and liabilities.

As explained in FASB ASC 820-10-35-37, in some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls should be determined based on the lowest level input that is significant to the fair value measurement in its entirety.

7.21 As discussed in FASB ASC 820-10-35-38, the availability of inputs relevant to the asset or liability and the relative reliability of the inputs might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques. For example, a fair value measurement using a present value technique might fall within level 2 or level 3, depending on the inputs that are significant to the measurement in its entirety and the level in the fair value hierarchy within which those inputs fall.

7.22 As stated by FASB ASC 820-10-35-15, the effect on a fair value measurement of a restriction on the sale or use of an asset by a reporting entity will differ depending on whether the restriction would be considered by market participants in pricing the asset. Example 6 (paragraphs 51–55) of FASB ASC 820-10-55 explains that restrictions that are an attribute of an asset, and therefore would transfer to a market participant, are the only restrictions reflected in fair value.

7.23 As mentioned previously, FASB ASC 820 precludes the use of a blockage factor when using level 1 inputs to measure fair value. FASB ASC 820-10-35-44 states 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 should be measured within level 1 as the product of the quoted price for the individual instrument and the quantity held. The quoted price should 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.

7.24 FASB ASC 820-10-35-56 states 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). U.S. GAAP, as stated in FASB ASC 820-10-35-57, 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.

Fair Value Determination When the Volume or Level of Activity Has Significantly Decreased

7.25 Paragraphs 51A–51H of FASB ASC 820-10-35 clarify the application of FASB ASC 820 in determining fair value when the volume and level of activity for the asset or liability has significantly decreased. Guidance is also included in identifying transactions that are not orderly. In addition, select paragraphs of 59A–59I of FASB ASC 820-10-55 provide illustrations on the application of this guidance.

7.26 This guidance does not apply to quoted prices for an identical asset or liability in an active market (level 1 inputs). For example, although the volume and level of activity for an asset or liability may significantly decrease, transactions for the asset or liability may still occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

7.27 Consistent with FASB ASC 820-10-35-51D, when determining fair value when the volume and level of activity for the asset or liability has significantly decreased, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. FASB ASC 820-10-35-51A lists a number of factors that may be evaluated to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability (or similar assets or liabilities) when compared with normal market activity. According to FASB ASC 820-10-35-51B, if, after evaluating the factors, the conclusion is reached that there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market conditions, transactions or quoted prices may not be determinative of fair value. Further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with FASB ASC 820-10. According to FASB ASC 820-10-35-51C, the objective is to determine the point within the range of fair value estimates that is most representative of fair value under the current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.

7.28 FASB ASC 820-10-35-51D states that determining the price at which willing market participants would transact at the measurement date under current market conditions if there has been a significant decrease in the volume and level of activity for the asset or liability depends on the facts and circumstances and requires the use of significant judgment. The reporting entity's intention to hold the asset or liability is not relevant, however, because fair value is a market-based measurement, not an entity-specific measurement.

7.29 According to FASB ASC 820-10-35-51E, an entity should evaluate the circumstances to determine whether the transaction is orderly based on the weight of the evidence. Circumstances that may indicate that a transaction is not orderly and guidance that should be considered in the determination are found in paragraphs 51E–51F of FASB ASC 820-10-35. Even if there has been a significant decrease in the volume and level of activity for the asset or liability, it is not appropriate to conclude that all transactions are not orderly (that is, distressed or forced). In making the determination concerning whether a transaction is orderly, an entity does not need to undertake all possible efforts but should not ignore information that is available without undue cost and

effort. The reporting entity would be expected to have sufficient information to conclude whether a transaction is orderly when it is party to the transaction. Refer to FASB ASC 820 for more information.

Disclosures

7.30 FASB ASC 820-10-50 discusses the disclosures required for assets and liabilities measured at fair value. For assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition or that are measured on a nonrecurring basis in periods subsequent to initial recognition, FASB ASC 820-10-50 requires the reporting entity to disclose certain information that enables users of its financial statements to assess the inputs used to develop those measurements. For recurring fair value measurements using significant unobservable inputs (level 3), the reporting entity is required to disclose certain information to help users assess the effect of the measurements on earnings for the period.[‡]

7.31 FASB ASC 820 encourages entities to combine the fair value information disclosed under that topic with the fair value information disclosed under other accounting topics, including FASB ASC 825, *Financial Instruments*, where practicable.

Fair Value Option

7.32 FASB ASC 825 creates a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measure for many financial instruments and certain other items, with changes in fair value recognized in the statement of activities as those changes occur. An election is made on an instrument-by-instrument basis (with certain exceptions) on its election date. Generally this is when an instrument is initially recognized in the financial statements. See FASB ASC 825-10-25-4 for information on election dates for specific eligible items that are other than when the instrument is initially recognized in the financial statements. The fair value option need not be applied to all identical items, except as required by FASB ASC 825-10-25-7. FASB ASC 825-10-15-4 notes that recognized financial assets and financial liabilities are eligible except those specifically listed. (See paragraph 7.33 for those items excluded from the election.) In addition to the eligible financial instruments, certain other items are eligible for the election such as firm commitments for financial instruments and certain nonfinancial contracts. FASB ASC 825-10-35-4 explains that a business should report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date.

7.33 FASB ASC 825-10-15-5 lists those instruments that are not eligible for the fair value option. Specifically excluded from eligibility is an investment

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‡ In January 2010, FASB issued ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. This ASU establishes new disclosure requirements regarding transfers in and out of levels 1 and 2 of the fair value hierarchy and activity in level 3 fair value measurements. It also clarifies certain existing disclosures within FASB ASC 820-10-50 regarding level of disaggregation and inputs and valuation techniques. The amendments in this ASU will be effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures in the level 3 fair value measurement roll forward. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Examples related to the guidance in this ASU were added to FASB ASC 820-10-55. The guidance referenced in this paragraph is amended by this ASU. Readers are encouraged to review the ASU in its entirety.

in a subsidiary that the entity is required to consolidate, an interest in a variable interest entity (VIE) that the entity is required to consolidate, employer's and plan's obligations for pension benefits, other postretirement benefits (including health care and life insurance benefits), postemployment benefits and deferred compensation arrangements (or assets representing overfunded positions in those plans), financial assets and liabilities recognized under leases (this does not apply to a guarantee of a third-party lease obligation or a contingent obligation arising from a cancelled lease), deposit liabilities of depository institutions, and financial instruments that are, in whole or in part, classified by the issuer as a component of shareholders' equity (including temporary equity).

7.34 FASB ASC 825-10-45 and 825-10-50 also include presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. Paragraphs 1–2 of FASB ASC 825-10-45 state that entities should report assets and liabilities that are measured using the fair value option in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute. To accomplish that, an entity should either (*a*) report the aggregate carrying amount for both fair value and non-fair-value items on a single line, with the fair value amount parenthetically disclosed or (*b*) present separate lines for the fair value carrying amounts and the non-fair-value carrying amounts. As discussed in FASB ASC 825-10-25-3, upfront costs and fees, such as debt issue costs, may not be deferred for items for which the fair value option has been elected.

Additional Fair Value Considerations[||]

Financial Instruments Listed on a Recognized Exchange

7.35 Ordinarily, management values a financial instrument traded on a recognized exchange[1] based on quotations of completed transactions. This is consistent with the guidance in FASB ASC 820. A financial instrument traded on a recognized exchange on the valuation date is usually valued at the last quoted sales price. Such prices are published daily. In the case of a financial instrument listed on more than one recognized exchange, the financial instrument is valued at the last quoted sales price on the exchange on which the

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[||] In September 2009, FASB issued ASU No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)* . ASU No. 2009-12 provides guidance on using the net asset value per share provided by investees to estimate the fair value of an alternative investment. ASU No. 2009-12 provides amendments to FASB ASC 820, *Fair Value Measurements and Disclosures*, for the fair value measurement of investments in certain entities that calculate net asset value per share and requires disclosures by major category of investments about the attributes of those investments. See ASU No. 2009-12 for further guidance.

ASU No. 2009-12 requires disclosures by major category of investment about the attributes of investments within the scope of ASU No. 2009-12. ASU No. 2009-12 is effective for interim and annual periods ending after December 15, 2009. Early application is permitted in financial statements for earlier interim and annual periods that have not been issued. If an entity early adopts the measurement amendments of ASU No. 2009-12, the entity is permitted to defer the adoption of the disclosure provisions of FASB ASC 820-10-50-6A until periods ending after December 15, 2009.

This guidance is located in FASB ASC 820-10-15, FASB ASC 820-10-35, FASB ASC 820-10-50, and FASB ASC 820-10-55 and is labeled as "Pending Content" due to the transition and effective date information discussed in FASB ASC 820-10-65-6.

[1] Reference to a recognized exchange includes the National Association of Securities Dealers Automated Quotation System, now known as the NASDAQ Stock Market.

financial instrument is principally traded. A financial instrument traded primarily on foreign exchanges is valued at the U.S. dollar equivalent, generally at the closing sales price on the principal exchange where it is traded.

7.36 FASB ASC 820-10-35-5 states that in the absence of a principal market, the most advantageous market is used. In either case, the principal (or most advantageous) market should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities.

7.37 The FASB ASC glossary defines *level 1 inputs* as quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. FASB 820-10-35-41 states that a quoted price in an active market provides the most reliable evidence of fair value and should be used to measure fair value whenever available. However, in some situations a quoted price in an active market might not represent fair value at the measurement date.[2] In the event that a market price is not representative of fair value due to significant events that occur after the close of market but before the measurement date, the entity should establish and consistently apply a policy for identifying those events that might affect fair value measurements.

7.38 According to FASB ASC 820-10-35-24, valuation techniques that are appropriate in the circumstances, and for which sufficient data are available, should be used to measure fair value. In some cases a single valuation technique will be appropriate—for example, when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities. In other cases, multiple valuation techniques will be appropriate.

7.39 Broker-dealers generally value their portfolios at the time of the close of trading on the principal exchange on which the financial instruments are traded. Related financial instruments may be traded in tandem, for example, as part of an arbitrage-trading strategy whose profitability is determined by the relative value of the financial instruments. It is appropriate to review the prices occurring on different exchanges or in different markets for all the individual financial instruments in the trading strategy at a given time in order to assign the proper value to all securities encompassed in that financial strategy.

Financial Instruments Not Listed on a Recognized Exchange but Having a Readily Available Market Price

7.40 Nonexchange-traded financial instruments are often traded in over-the-counter (OTC) markets by dealers or other intermediaries from whom market prices are obtainable. Quotations are available from various sources for many financial instruments traded regularly in the OTC market. Those sources include the financial press, various quotation publications and financial reporting services, and individual market makers.

7.41 Financial instruments not listed on a recognized exchange are more likely to be valued using level 2 or level 3 inputs (as opposed to level 1 inputs).

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[2] See paragraphs 42–43 of FASB ASC 820-10-35 for instances in which a quoted price in an active market may not be representative of fair value. See also the discussion beginning at paragraph 7.25 for information on determining fair value when the volume and level of activity for an asset or liability has significantly decreased.

If there is a limited amount of trading activity for a financial instrument (that is, if the instrument is thinly traded), the reliability of the market quotation and other market information (for example, volume data) should be evaluated by management. In instances where the fair value, as determined by management, is lower than the market quotation for a similar, but not identical financial instrument, the financial instruments should be valued at such fair value. See paragraph 7.20 for more information on the three levels of inputs to valuation techniques.

7.42 Paragraphs 50–51 of FASB ASC 820-10-35 explain that adjustments to level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition or location or both of the asset or liability, the extent to which the inputs relate to items that are comparable to the asset or liability (including those factors discussed in FASB ASC 820-10-35-16D), and the volume and level of activity in the markets within which the inputs are observed. As noted in paragraph 7.20, a significant adjustment to a level 2 fair value measurement might render the measurement a level 3 measurement depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall.

7.43 As discussed in FASB ASC 940-820-50-1, notes to the financial statements should disclose all of the following if financial instruments are valued at lower than quoted market prices:

- Description of the financial instrument
- Total value of the financial instrument as measured by the quoted market price
- Total value reported in the statement of financial condition
- Methods and significant assumptions used to value the instruments at lower than the quoted market price.

Financial Instruments Not Having a Readily Available Market Price

7.44 A broker-dealer may have to determine the fair values of financial instruments for which there are no readily available price quotations or for which readily available price quotations are unreliable. These price quotations may be deemed unreliable because of a variety of reasons. For example, the financial instruments may have restrictions associated with them (such as not being registered) or the entity may have been forced to sell due to financial difficulties. In such cases, it may be appropriate for these financial instruments to be valued at fair value using level 3 inputs as found in FASB ASC 820. See also the discussion beginning at paragraph 7.25.

7.45 As noted in the FASB ASC glossary, *level 3 inputs* are unobservable inputs for the asset or liability. According to paragraphs 53 and 55 of FASB ASC 820-10-35, unobservable inputs are used to measure fair value to the extent that observable inputs are not available. Unobservable inputs should reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liabilities (including assumptions about risk). Unobservable inputs should be developed based on the best information available in the circumstances, which might include the reporting entity's own data.

7.46 Management of the reporting entity should take into consideration all indications of value that are reasonably available in determining the fair value assigned to a particular financial instrument. The information considered and the basis for the decision should be documented. This guide does not purport to delineate all factors that may be considered.

7.47 As noted in FASB ASC 940-820-30-1, the following is a list of certain factors that have been taken into consideration by broker-dealers as part of the determination of fair value:[3,4]

- Financial standing of the issuer
- Business and financial plan of the issuer
- Cost at date of purchase
- Size of position held and the liquidity of the market
- Contractual restrictions on salability
- Pending public offering with respect to the financial instrument
- Pending reorganization activity affecting the financial instrument (such as merger proposals, tender offers, debt restructurings, and conversions)
- Reported prices and the extent of public trading in similar financial instruments of the issuer or comparable entities
- Ability of the issuer to obtain needed financing
- Changes in the economic conditions affecting the issuer
- A recent purchase or sale of a security of the entity
- Pricing by other dealers in similar securities

7.48 Management may use a variety of methods to assist in determining the valuation of a financial instrument. These methods include analogy to reliable quotations of similar financial instruments, pricing models, matrix pricing, and other formula-based pricing methods. These methodologies incorporate factors for which published market data may be available. For instance, the mathematical technique known as *matrix pricing* may be used to determine the values based on market data available with respect to the issue and similar issues without exclusive reliance on issuer-specific quoted market prices.[5]

7.49 Pricing methods may also be based on a multiple of earnings or a discount (or less frequently, a premium) from market of a similar, freely traded security; on a yield to maturity with respect to debt issues; or on a combination of these and other methods. In addition, with respect to derivative products, other factors (such as volatility, anticipated future interest rates, and term to maturity) should be considered. (The Group of Thirty Report *Derivatives: Practices and Principles*[6] contains several recommendations regarding dealers'

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[3] The Securities and Exchange Commission's (SEC's) *Codification of Financial Reporting Policies* provides guidance on the factors to be considered, and on the methods used to value securities for which market quotations are not readily available. FASB ASC 820-10-35 also provides guidance on the valuation of financial instruments for which market quotations are not readily available.

[4] FASB ASC 820-10-35-44 does not allow a blockage factor to be used when level 1 inputs are used to measure fair value. See paragraph 7.20 for more information.

[5] FASB ASC 820-10-35-42 notes that matrix pricing is an alternative measurement that renders the fair value measurement a lower level measurement.

[6] Group of Thirty. *Derivatives: Practices and Principles*. Washington, DC: Group of Thirty, 1993, and *Enhancing Public Confidence in Financial Reporting*. Washington D.C: Group of Thirty, 2003. [Group of Thirty, 1990 M Street, N.W., Washington, DC 20036].

pricing, including that derivative portfolios be valued based on mid-market levels less specific adjustments.) If such methods are used, management should continuously review the appropriateness of such methods to satisfy themselves that the resulting valuations are fair and in compliance with FASB ASC 820.

Trade-Date Versus Settlement-Date Accounting

7.50 Broker-dealers execute a wide variety of transactions in financial instruments for their own accounts (proprietary transactions, also referred to as principal transactions) or on behalf of customers (agency transactions). The transactions usually involve at least two important dates.

trade date. The date on which an agreement (an executory contract) is entered into, setting forth the important aspects of the transaction (such as a description of the instruments, quantity, price, delivery terms, and so forth).

settlement date. The date on which the financial instrument is required to be delivered to the purchaser and consideration paid. Depending on the particular transaction, the settlement date could be as early as the same day as the trade date or as far away as months (and sometimes more than a year) after the trade date.

7.51 The settlement date is generally established by convention or by regulations of the market in which the transaction is executed (for instance, regular-way trades executed on the floor of a stock exchange); for certain types of transactions, the settlement date is based on the terms agreed to by the parties (for instance, forward transactions).

7.52 Although the terms for each type of transaction may differ in many respects, they tend to have the following two major aspects in common:

a. On the trade date, the purchaser assumes the risks and rewards of further changes in the value of the underlying financial instrument.

b. On the settlement date, the seller is required to deliver and the purchaser is required to pay for the financial instrument.

Proprietary/Principal Transactions

7.53 As explained in FASB ASC 940-320-25-1, the statement of financial condition should reflect all regular-way trades on an accrual or trade-date basis. Risk, benefits, and economic potentials are created and conveyed at the trade date (that is, the inception of the contract), which is when the major terms have been agreed to by the parties. In order to properly reflect the economic effects of purchase and sale transactions for financial instruments (that is, to reflect the assumption of the risks and rewards resulting from changes in the value of financial instruments), broker-dealers should account for the changes in value relating to all proprietary/principal transactions on a trade-date basis.

7.54 For example, as stated in FASB ASC 940-320-25-2, if the broker-dealer purchased financial instruments for its own account on the date of the statement of financial condition, the transaction should be reflected in the broker-dealer's inventory with a corresponding credit to net receivable or payable for unsettled regular-way trades. Per the FASB ASC glossary, *regular-way trades* include the following: (*a*) all transactions in exchange-traded

financial instruments that are expected to settle within the standard settlement cycle of that exchange (for example, three days for United States securities exchanges); and (*b*) all transactions in cash-market-traded financial instruments that are expected to settle within the time frame prevalent or traditional for each specific instrument (for example, for U.S. government securities, one or two days).

7.55 For physical commodities (such as lumber, crude oil, and precious metals), the prevalent trade practice for recording such transactions should be followed, which is typically when title passes.

7.56 As noted in FASB ASC 940-320-05-4, the risk of nonperformance of regular-way settling trades is minimal given the following: (*a*) they are fully collateralized on the trade date; (*b*) the period of time between trade date and settlement date is reasonably short; and (*c*) most equity, U.S. government, and mortgage-backed agency securities are affirmed by both parties to the trade and settle net through a clearing entity. Accordingly, FASB ASC 940-20-45-3 states that payables and receivables arising from these unsettled regular-way transactions may be recorded net in an account titled net receivable (or payable) for unsettled regular-way trades.

7.57 According to FASB ASC 820-10, contracts that are defined as derivative instruments according to FASB ASC 815, *Derivatives and Hedging*, should be measured at fair value and recognized in the statement of financial condition as either assets or liabilities depending on the rights or obligations under the contracts. The fair values of these contracts or of accrued receivables or payables arising from the contracts may be offset only if the provisions of FASB ASC 210-20 are met.

7.58 Certain other contracts are also recognized in the financial statements of broker-dealers on a trade-date basis. The fair values of unsettled delayed-delivery and to-be-announced securities trades should be based on prices for forward-settling trades. For example, a foreign-exchange forward contract may call for a party to deliver two million U.S. dollars in exchange for two million British pounds sterling at a specified future date. Under current reporting practice, the party would not record a receivable for the British pounds sterling or a payable for the U.S. dollars. Rather, a net amount reflecting the fair value of the position would be reported in the statement of financial condition.

7.59 Per FASB ASC 940-320-25-2, if the exchange does not occur on the contracted settlement date (referred to as a *fail-to-deliver* or *fail-to-receive*), these transactions should be recognized on the statement of financial condition as fails-to-deliver or fails-to-receive.

7.60 The receivables and payables resulting from these failed transactions may be netted for financial statement reporting purposes to the extent the provisions of FASB ASC 210-20 are met.

Agency Transactions

7.61 FASB ASC 940-20-25-1 explains that transactions executed by broker-dealers as agents for customers are not reflected in the statement of financial condition of the broker-dealer unless the transaction fails to settle on the contracted settlement date. Because the broker-dealer typically delivers cash or financial instruments on behalf of the customer, if the customer fails on the settlement date, the broker-dealer is required to record the transaction

(for example, as a fail-to-receive from customer, payable to customer, or stock borrowed or loaned on behalf of customer).

7.62 In accordance with FASB ASC 940-20-25-2, for securities purchased, commissions should be recorded as a receivable from customers; for securities sold, commissions should be recorded as reductions in the payable to customers. The commission income and related expenses are accrued by the broker-dealer on the trade date because substantially all the efforts in generating the commissions have been completed.

7.63 Unlike a principal transaction, where the broker-dealer is the counterparty to the transaction with the customer and thus, would have the securities transactions flow through its inventory as it is *acting in a dealer capacity*, in an agency transaction the broker-dealer is simply a middleman between two counterparties, and thus, the securities transaction does not flow through its inventory as it is *acting in a broker capacity*.

Statement-of-Financial-Condition Considerations

Due From and Due to Other Broker-Dealers and Clearing Entities

7.64 Amounts due from and due to other broker-dealers and clearing entities may arise from the following:

- Net receivables or payables arising from unsettled regular-way transactions
- Securities borrowed and loaned
- Failed settlement transactions
- Clearing entity balances
- Commissions
- Deposits

7.65 Balances arising from the foregoing, with the exception of the net payable or receivable arising from unsettled transactions, are reported gross on the statement of financial condition, unless the provisions of FASB ASC 210-20 are met. For example, a broker-dealer may report on a net basis payables and receivables associated with clearing through a clearing entity that provides for and guarantees net settlement balances because the criteria of FASB ASC 210-20 are met. FASB ASC 210-20-45-9 discusses the nature of support required for an assertion in financial statements that a right of setoff is enforceable at law.

Secured Borrowings

7.66 Broker-dealers enter into a variety of transactions that may be required to be accounted for either as sales of securities or as secured borrowings,[7] depending on the terms of the particular transaction. These include securities borrowing and lending transactions, repurchase (repo) and reverse repurchase (reverse repo) agreements, and dollar repurchase agreements (dollar rolls).

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[7] Secured borrowings, as that term is used in FASB ASC 860, *Transfers and Servicing*, are also sometimes referred to as *collateralized financings*.

7.67 Securities lending transactions are documented as loans of securities in which the borrower of securities generally is required to provide collateral to the lender of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities borrowed. If the collateral is cash, the lender of securities typically earns a return by investing that cash at rates higher than the rate paid or rebated to the borrower. If the collateral is other than cash, the lender of securities typically receives a fee.

7.68 Repo and reverse repo agreements are typically documented as sales/purchases of securities with forward purchase/sales contracts. In a repo agreement, a security is sold with an agreement to repurchase the security from the buyer; in a reverse repo agreement, a security is purchased with an agreement to resell the security to the seller-lender at a stated price plus interest at a specific date or in specified circumstances.[8]

7.69 The FASB ASC glossary defines *dollar roll repurchase agreements* (dollar rolls) as agreements to sell and repurchase similar but not identical securities. Dollar rolls differ from regular repo agreements in that the securities sold and repurchased, which are usually of the same issuer, are represented by different certificates, are collateralized by different but similar mortgage pools (for example, conforming single-family residential mortgages), and generally have different principal amounts. The most common types of dollar rolls are fixed-coupon and yield-maintenance arrangements.

7.70 FASB ASC 860, *Transfers and Servicing*, [9] sets forth standards for distinguishing transfers of financial assets that are to be accounted for as sales from transfers that are to be accounted for as secured borrowings.[#] Paragraphs 4–5 of FASB ASC 860-10-40 state the following:

> A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets should be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:
>
> *a*. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy

[8] In certain industries, the terminology is reversed.

[9] Further discussion of FASB ASC 860 can be found beginning at paragraph 7.79.

[#] In December 2009, FASB issued ASU No. 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*, which incorporated FASB Statement No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140* (issued in June 2009), into FASB ASC. This guidance will require more information about transfers of financial assets, including securitization transactions, and where entities have continuing exposure to the risks related to transferred financial assets. It also eliminates the concept of a qualifying special purpose entity, changes the requirements for derecognizing financial assets, and requires additional disclosures. This guidance is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. Earlier application is prohibited. This guidance must be applied to transfers occurring on or after the effective date; however, the disclosure provisions should be applied to transfers that occurred both before and after the effective date.

As of the date of this guide, July 2010, this guidance can be found in "Pending Content" of FASB ASC and has not yet been included in this guide. This guidance will be incorporated into the next edition of the guide.

or other receivership (see paragraphs 7–14 of FASB ASC 860-10-40).

b. Each transferee (or, if the transferee is a qualifying special-purpose entity [SPE],[**] each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor (see paragraphs 15–21 of FASB ASC 860-10-40).

c. The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (see paragraphs 23–27 of FASB ASC 860-10-40) or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call (see paragraphs 28–39 of FASB ASC 860-10-40).

As noted in FASB ASC 860-30-25-2, if a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet these criteria for a sale, the transfer is to be accounted for by the transferor and transferee as a secured borrowing with a pledge of collateral.

7.71 FASB ASC 860-30-25-7 describes the accounting for securities lending transactions accounted for as secured borrowings in terms of the following:

> Cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as "collateral" is considered the amount borrowed, the securities "loaned" are considered pledged as collateral against the cash borrowed, and reclassified as set forth in FASB ASC 860-30-25-5(a), and any "rebate" paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed.

FASB ASC 860-30-25-8 states that the transferor of securities being "loaned" accounts for cash received in the same way whether the transfer is accounted for as a sale or a secured borrowing. Cash collateral or securities received as collateral that a securities lender is permitted to sell or repledge are the proceeds of a borrowing secured by them. The cash received should be recognized as the transferor's asset—as should investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash. If securities that may be sold or repledged are received, the transferor of the securities being "loaned" accounts for those securities in the same way as it would account for cash received.

7.72 FASB ASC 860-30-25-5 states that the accounting for noncash collateral by the debtor (or obligor) and the secured party depends on whether the secured party has the right to sell or repledge the collateral and on whether the debtor has defaulted. As noted in FASB ASC 860-30-25-4, cash "collateral," sometimes used, for example, in securities lending transactions, should be derecognized by the payer (obligor) and recognized by the recipient (secured party),

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[**] See footnote # for information on ASU No. 2009-16, which eliminates the concept of "qualifying special-purpose entity."

not as collateral, but rather as proceeds of either a sale or borrowing. FASB ASC 860-30 provides additional guidance on accounting for collateral.

7.73 Paragraphs 51 and 53 of FASB ASC 860-10-55 state the following with respect to repurchase agreements:

> As with securities lending transactions, under many agreements to repurchase transferred financial assets before their maturity the transferor maintains effective control over those financial assets. Repurchase agreements that do not meet all the criteria in FASB ASC 860-10-40-5 shall be treated as secured borrowings. Fixed-coupon and dollar-roll repurchase agreements, and other contracts under which the securities to be repurchased need not be the same as the securities sold, qualify as borrowings if the return of substantially the same (FASB ASC 860-10-40-24) securities as those concurrently transferred is assured. Therefore, those transactions shall be accounted for as secured borrowings by both parties to the transfer.

7.74 Balances arising from securities lending transactions that are accounted for as secured borrowings are reported gross on the statement of financial condition. Because securities-borrowed and securities-loaned transactions do not typically have explicit settlement dates, they do not meet the requirement, in FASB ASC 210-20-45-1(c) that the reporting party intends to set off. Balances arising from repo transactions treated as secured borrowings should be reported gross in the statement of financial condition unless all of the provisions of FASB ASC 210-20-45-11, are met. FASB ASC 210-20-45-11 may be applied only to repo and reverse repo transactions.

Exchange Memberships Owned or Contributed

7.75 As discussed in FASB ASC 940-340-25-1, the accounting for exchange memberships depends on the rights they convey and the reasons they are held as assets, as follows:

a. *Ownership interest in the exchange*. An exchange membership should be accounted for as an ownership interest in the exchange if the exchange membership represents (1) both an ownership interest and the right to conduct business on the exchange, which are owned by a broker-dealer and held for operating purposes, or (2) an ownership interest, which must be held by a broker-dealer to conduct business on the exchange. In accordance with FASB ASC 940-340-30-1 and 940-340-35-1 an ownership interest in the exchange should be accounted for initially and subsequently at cost or at a lesser amount if there is an other-than-temporary impairment in value.

b. *Intangible asset*. An exchange membership should be accounted for as an intangible asset in accordance with FASB ASC 350-10, if it represents only the right to conduct business on an exchange. Such memberships may have finite or indefinite lives based on the terms of the arrangement and the estimated life of the membership.

c. *Contributed interest*. A membership may be considered to be an asset of the broker-dealer if its use has been contributed to the broker-dealer under a formal or informal subordination agreement. An exchange membership contributed for the use of the broker-dealer and subordinated to claims of general creditors should be accounted for

as a contributed interest and a liability subordinated to claims of general creditors. In accordance with FASB ASC 940-340-30-2 and 940-340-35-2, this type of exchange membership should be recorded initially and subsequently at fair value with an equal and offsetting amount recorded for the subordinated liability.

Suspense Accounts

7.76 FASB ASC 940-20-05-8 notes that because of the number of transactions that take place when trades are cleared for the broker-dealer or its customers, unreconciled differences and trading errors occur. A broker-dealer often has several suspense accounts to facilitate the identification and resolution of differences. Per FASB ASC 940-20-25-6, unreconciled differences are recorded at the amount of the transaction with an appropriate valuation account until a determination of the cause of the differences is made and the differences are resolved. Trading errors are recorded in the broker-dealer's error suspense account until they are resolved. FASB ASC 940-20-35-2 further states that the underlying securities are marked to market, and the gain or loss is recognized in income.

Conditional Transactions

7.77 FASB ASC 940-20-25-7 notes that certain transactions (for example, those for when-issued securities) are, by their nature, conditional; that is, their completion is dependent on the occurrence of a future event or events. For those conditional transactions in which completion is assured beyond a reasonable doubt, the recognition of the transactions and related profit and loss should be the same as for unconditional transactions. For those conditional transactions in which completion is not assured beyond a reasonable doubt, only mark to market losses should be recognized, whereas market value gains should be deferred. For the scope application of FASB ASC 815 to contracts for the purchase or sale of when-issued securities or other securities that do not yet exist, see FASB ASC 815-10-15-17. (See also the "Derivatives" section in this chapter for a discussion of FASB ASC 815.)

Leveraged Buyouts and Bridge Loans

7.78 As noted in FASB ASC 940-325-05-1, a broker-dealer may make investments in the form of equity or provide financing to another entity in connection with financial-restructuring transactions. These investments may take many forms, including a direct investment or an investment in an entity (sometimes referred to as a *bridge entity*) that is established for the purpose of accumulating funds from several sources sufficient to make the investment. FASB ASC 940-325-30-1 and 940-325-35-1 state that investments in the form of equity or financing provided to another entity in connection with financial-restructuring transactions should be initially and subsequently presented at fair value. As stated in FASB ASC 940-810-45-1, a majority owned entity that is not in the scope of the "Variable Interest Entity" subsection of FASB ASC 810-10-15, and in which a parent has a controlling financial interest, should not be consolidated if the parent is a broker dealer and control is likely to be temporary.

Asset Securitizations

7.79 The complexity of securitized products has increased significantly because of the nature of underlying collateral, the complexity of the structure

(for example, residual tranches and interest- and principal-only strips), and the depth of markets. Such factors have affected the accounting and valuation of those products. Broker-dealers may acquire, either through market purchases or through the underwriting process, securities arising from asset securitizations. Those securities should be valued at fair value in accordance with the guidelines discussed previously.

7.80 FASB ASC 860-50-30-1 requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable. FASB ASC 860-50-35-1 permits, but does not require, the subsequent measurement of separately recognized servicing assets and servicing liabilities at fair value.

7.81 An entity that uses derivative instruments to mitigate the risks inherent in servicing assets and servicing liabilities is required to account for those derivative instruments at fair value. An entity can elect subsequent fair value measurement to account for its separately recognized servicing assets and servicing liabilities. By electing that option, an entity may simplify its accounting because that option permits income statement recognition of the potential offsetting changes in fair value of those servicing assets and servicing liabilities and derivative instruments in the same accounting period.

7.82 In addition, certain securities that arise from asset securitizations may raise issues about whether the underlying legal entity should be consolidated by the broker-dealer. FASB ASC 860 provides guidance on the securitization of financial assets held by broker-dealers and for other transfers of financial assets involving SPEs. In a typical asset securitization transaction, a company transfers assets to a special-purpose vehicle (SPV) or VIE in exchange for cash or securities issued by the SPV or VIE. Many securitization vehicles meet the FASB ASC glossary definition of a *qualifying SPE*.[††] Qualifying SPEs are not consolidated under guidance in FASB ASC 860. Securitization vehicles that do not qualify as qualifying SPEs need to be evaluated under FASB ASC 810, *Consolidation*, to determine if the broker-dealer is the primary beneficiary of the VIE and therefore should consolidate the VIE or if the broker-dealer holds a significant variable interest in the VIE and should make the appropriate disclosures.

Variable Interest Entities[‡‡]

7.83 FASB ASC 810 addresses consolidation by business entities of VIEs with certain characteristics. A *VIE*, as defined by the FASB ASC glossary, is a

[††] See footnote # in paragraph 7.70.

[‡‡] ASU No. 2009-17, *Consolidations: Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*, incorporates into the codification the guidance from FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, which revises FASB Interpretation No. 46(R), and changes how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. This statement nullifies the guidance in FASB Staff Position (FSP) FAS 140-4 and FIN 46(R)-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities*. However, the content of the enhanced disclosures required by this statement is generally consistent with that previously required by the FSP. This guidance is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first

(continued)

legal entity subject to consolidation according to the provisions of the "Variable Interest Entity" subsections of FASB ASC 810-10. FASB ASC 810 addresses certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FASB ASC 810-10-50 includes disclosure requirements.

Derivatives

7.84 FASB ASC 815 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities.

7.85 FASB ASC 815-10-15-83 states that a derivative instrument is a financial instrument or other contract with all three of the following characteristics:

a. It has (1) one or more underlyings and (2) one or more notional amounts[10] or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required.

b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c. Its terms implicitly or explicitly require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

As noted in FASB ASC 815-10-15-71, notwithstanding the previously mentioned characteristics, loan commitments that relate to the origination of mortgage loans that will be held for sale, should be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender). FASB ASC 815-10-15-69 provides a scope exception for the accounting for certain loan commitments.

7.86 When recognizing certain loan commitments, SEC Staff Accounting Bulletin No. 109, *Written Loan Commitments Recorded at Fair Value Through Earnings*, provides guidance. This staff accounting bulletin provides interpretive guidance and emphasizes certain disclosure requirements that may be relevant in the context of mortgage banking activities.

(footnote continued)

annual reporting period and for interim and annual reporting periods thereafter. Earlier application is prohibited.

See also ASU No. 2010-10, *Consolidation (Topic 810): Amendments for Certain Investment Funds*, which defers the effective date of the consolidation requirements, as set forth in ASU No. 2009-17, to a reporting entity's interest in certain types of entities. This update does not defer the disclosure requirements under ASU No. 2009-17 regardless of whether the entity qualifies for the deferral related to consolidated reporting.

[10] *Notional amount* is the number of units specified in the contract (for example, shares, bushels, or other unit). Sometimes other names are used for the term *notional*. For example, the notional amount is called a *face amount* in some contracts.

7.87 Broker-dealers enter into derivative transactions to deal, to take proprietary positions, to effect economic hedges of instruments in other trading portfolios, to execute arbitrage strategies, or to hedge long-term debt or long-dated resale and repurchase transactions.

7.88 FASB ASC 815-10-05-4 requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial condition and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as (*a*) a hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized firm commitment, that are attributable to a particular risk (referred to as a fair value hedge), (*b*) a hedge of the exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk (referred to as a cash flow hedge), or (*c*) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a forecasted transaction.

7.89 As noted in FASB ASC 815-10-35-2, the accounting for changes in the fair value of a derivative instrument (that is, gains and losses) depends on whether it has been designated and qualifies as part of a hedging relationship and, if so, on the reason for holding it. The gain or loss on a derivative instrument not designated as a hedging instrument should be recognized currently in earnings, except as noted in FASB ASC 815-10-35-3. See FASB ASC 815-20 for guidance on the accounting for the gain or loss on a derivative instrument that is designated as a hedging instrument.

7.90 Derivatives entered into by dealers in connection with their dealing activities should be carried at fair value with resultant gains and losses reported currently in income. Quoted market prices provide the most reliable fair value for derivatives traded on a recognized exchange. Fair value for derivatives not traded on a recognized exchange is generally considered to be the value that could be realized through termination or assignment of the derivative. Common valuation methodologies for an interest rate swap incorporate a comparison of the yield of the swap with the current treasury security yield curve and swap to treasury spread quotations, or the current swap yield curve. The swap yield curve is derived from quoted swap rates. Dealer bid and offer quotes are generally available for basic interest rate swaps involving counterparties whose securities are investment-grade. (The Group of Thirty Report contains several recommendations regarding dealer pricing, including that derivatives portfolios be valued based on mid-market levels less specific adjustments.) Factors that could influence the valuation of an individual derivative include the counterparty's credit standing and the complexity of the derivative. If those factors differ from those basic factors underlying the quote, an adjustment to the quoted price should be considered.

7.91 In determining a derivative's value, consideration should be given to recognizing and providing for credit and liquidity risk and the operational and administrative costs associated with the management of derivative portfolios. The methods for determining the amount of credit risk and operational costs may differ among dealers.

7.92 FASB ASC 815-15-25-4 explains that an entity that initially recognizes a hybrid financial instrument that would otherwise be required to be

separated into a host contract and a derivative instrument may irrevocably elect to initially and subsequently measure that hybrid financial instrument in its entirety at fair value (with changes in fair value recognized in earnings). The financial instrument should be evaluated to determine that it has an embedded derivative requiring bifurcation before the instrument can become a candidate for the fair value election. FASB ASC 815-15-25-5 states that the recognized hybrid financial instrument could be an asset or a liability and it could be acquired or issued by the entity. Also, the fair value election may be made on an instrument-by-instrument basis at the inception of the hybrid instrument (or upon a remeasurement event) and should be supported by concurrent documentation or a preexisting documented policy for automatic election. For more information see the guidance at FASB ASC 815-15.

7.93 FASB ASC 815-10-50 provides guidance regarding the disclosures required in the notes to financial statements as related to derivatives.[11] Note that in some cases, the disclosures required for derivatives relate to disclosures that appear on the face of the financial statements.

Soft-Dollar Arrangements

7.94 According to the FASB ASC glossary, *soft-dollar arrangements* are arrangements in which a broker-dealer provides research to a customer in return for trade order flow (a certain volume of trades) from that customer. As noted in FASB ASC 940-20-05-4, these arrangements generate commission income for the broker-dealer. Many of these agreements are oral, and the value of the research to be provided is typically based on a percentage of commission income. Soft-dollar customers are typically institutional investors or money managers. Soft-dollar research may be generated either internally by the broker-dealer or purchased by the broker-dealer from a third party.

7.95 Since the 1970s, when soft dollars were first used, some broker-dealers and money managers have used soft dollars to cover transactions or expenses not associated with research. These types of transactions are governed by Section 28(e) of the Securities Exchange Act of 1934, which allows the paying of a brokerage commission if the manager determines in good faith that the commission is reasonable in relation to the value of the brokerage and research services provided.[12]

7.96 FASB ASC 940-20-25-3 explains that at the date of the statement of financial condition, the broker-dealer should analyze both the commission income generated from soft-dollar customers and the research provided to the soft-dollar customers to determine whether a liability should be accrued for research due to customers based on the commission income generated or whether any soft dollar expenses have been prepaid and need to be deferred.

7.97 The realizability of any prepaid expenses should be evaluated as of the financial statement date.

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[11] See chapter 4, "Financial Statement Presentation and Classification," for information on disclosures related to derivative instruments.

[12] On July 18, 2006, the SEC published final interpretative guidance (SEC Release No. 54165) regarding the "soft dollar" safe harbor of Section 28(e) of the Securities Exchange Act of 1934. The release more clearly defines the boundaries of permissible "research" and "brokerage" products under the safe harbor.

Mandatorily Redeemable Instruments

7.98 FASB ASC 480,[||||] *Distinguishing Liabilities from Equity*, establishes standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. The guidance requires that an issuer classify a financial instrument within its scope as a liability (or an asset in some circumstances). A financial instrument issued in the form of shares is a *mandatorily redeemable instrument*, and is therefore within the scope of the topic, if it embodies an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event certain to occur. (According to the FASB ASC glossary, the term *shares* includes various forms of ownership that may not take the legal form of securities, for example, partnership interests, as well as other interests, including those that are liabilities in substance but not in form.)

7.99 Such obligation as mentioned in the previous paragraph may arise from the terms of the operating, partnership or incorporation agreement, or the operation of state law.

7.100 Under FASB ASC 480-10-55, broker-dealers that have issued shares that must be sold back to the company upon the holder's death or termination of employment should record those shares as liabilities, rather than equity, because the shares are mandatorily redeemable upon an event certain to occur. As a result, some broker-dealers may report minimal or no equity in their U.S. GAAP financial statements. From a regulatory standpoint, application of FASB ASC 480 can (*a*) cause a broker-dealer to fall below its minimum net capital requirements under Rule 15c3-l(a), or (*b*) cause its subordinated debt to debt-equity total to increase above the 70 percent limit set forth in Rule 15c3-l(d). Broker-dealers may have amended, partnership, operating (such as limited liability company), shareholder, or other agreements to avoid the potential adverse impacts of FASB ASC 480 on net capital.

Statement-of-Income/Loss Considerations

Underwriting Revenues and Expenses

7.101 As noted in FASB ASC 940-20-05-10, there are several different ways in which a broker-dealer may participate in the underwriting of a new issue of securities. The broker-dealer may be the managing or lead underwriter, a member of the syndicate, or a member of the selling group. Such participation may be on one of the following bases:

- Firm commitment
- Standby
- Best efforts
- All or none

[||||] This guidance is located in FASB ASC 480, *Distinguishing Liabilities from Equity*, and is labeled as "Pending Content" due to the transition and open effective date information related to mandatorily redeemable financial instruments of certain nonpublic entities and for certain mandatorily redeemable noncontrolling interests, as discussed in FASB ASC 480-10-65-1.

7.102 FASB ASC 940-340-05-1(b) notes that in connection with its participation in an underwriting of securities, a broker-dealer may receive various types of revenues as well as incur various related expenses. Such revenues include management fees (in the case of the lead or comanaging underwriter), underwriting fees (in the case of the lead underwriter and other members of the syndicate), and selling concession fees (in the case of all selling group members). The related expenses include but are not limited to marketing and advertising fees, legal fees, stabilization costs, and the other costs associated with setting up the syndicate group. These expenses are accumulated by the lead underwriter and are allocated to the other members of the syndicate on a pro rata basis.

7.103 As discussed in FASB ASC 940-605-25-2, the fee revenue relating to the underwriting commitment should be recorded when all significant items relating to the underwriting cycle have been completed and the amount of the underwriting revenue has been determined. This will generally be at the point at which all of the following have occurred (which may or may not be prior to the settlement date of the issue):

- The issuer's registration statement has become effective with the SEC, or other offering documents are finalized (as opposed to the closing or settlement date).
- The broker-dealer has made a firm commitment for the purchase of the shares or debt from the issuer.
- The broker-dealer has been informed of the exact number of shares or the principal amount of debt that it has been allotted (if it is not the lead underwriter of an undivided offering).

7.104 FASB ASC 940-340-25-3 and 940-340-35-3 state that when the related underwriting expenses described previously are incurred prior to the actual issuance of the securities, such expenses are deferred and recognized at the time the related revenues are recorded. In the event that the transaction is not completed and the securities are not issued, the entities that have agreed to participate in the costs associated with the underwriting write those costs off to expense.

7.105 According to FASB ASC 940-20-35-3, with respect to the underwriting of issues that trade prior to the settlement date, the broker-dealer should mark to market any shares that it is firmly committed to purchase but that have not yet been subscribed to by customers.

Mutual Fund Distribution Costs

7.106 FASB ASC 940-20-05-5 notes that broker-dealers may contract with one or more mutual funds to act as the registered distributor of the mutual fund's shares, assisting the fund in selling and distributing its shares. If a broker-dealer undertakes the responsibility for selling and distributing fund shares, it will incur different types of costs, the most common of which are commissions paid to those of its representatives who arrange fund sales. To compensate a broker-dealer for those selling efforts, mutual funds may establish some form of a fund-charge and shareholder-commission structure that provides fees to the broker-dealer either at the time of sale or over a specified period of time. Two common forms of compensation are the following:

- A front-end commission paid to the broker-dealer by the fund shareholder at the time of sale
- A 12b-1 distribution fee, which is paid by the fund over a period of time based on a percentage of the fund's daily net asset levels, together with a deferred sales charge, which is a commission paid to the broker-dealer by the shareholder at the time the shareholder exits the fund. Deferred sales charges are often charged to the shareholder in decreasing amounts over time.

7.107 In accordance with FASB ASC 940-605-25-3, a front-end commission should be recorded in full by the broker-dealer at the time it is earned (the trade date). FASB ASC 940-605-25-4 further notes that with respect to 12b-1 fees and deferred sales charges, the broker-dealer generally defers its incremental direct costs associated with the selling of the fund shares (such as sales representatives' commissions and direct marketing costs) and amortizes these costs over the period in which the fees from the fund or fund shareholders are expected to be received. Indirect costs associated with selling the fund shares are expensed as incurred.

7.108 Fees from the funds or fund shareholders are recognized when received (see FASB ASC 946-605-25-8).

Half-Turn Convention

7.109 According to FASB ASC 940-605-30-1, commissions on certain contracts, such as commodity futures and options, may be billed to customers on a round-turn basis. The FASB ASC glossary defines *round-turn* as a purchase and a subsequent sale, or a sale and a subsequent purchase, of a commodity futures contract. As explained in FASB ASC 940-605-30-2, even though the round-turn commissions may be reflected in the customer's account upon entering into the transaction or on the date of the round turn, this commission income should be recognized in the statement of income on a half-turn basis. Per the FASB ASC glossary, *half-turn* is a transaction involving the purchase or sale as either an opening or closing transaction of a commodity futures contract.

Interest, Dividends, and Rebates

7.110 The income statement classification of interest, dividends, and rebate income and expense varies, because certain transactions are entered into as financings and others are entered into as part of trading strategies.

7.111 FASB ASC 940-405-45-1 states that stock-loan and repo transactions may be entered into for the purpose of financing positions (such as in lieu of a bank loan). If such transactions are accounted for as financing transactions (see the discussion in this chapter titled "Secured Borrowings" that begins in paragraph 7.66), the rebate or interest expense should be reflected in the income statement as an expense separate and apart from any trading gains or losses.

7.112 However, FASB ASC 940-320-05-3 notes that broker-dealers frequently enter into matched-stock borrow and loan transactions as a finder or conduit, or enter into repo and reverse repo agreements as part of a matched-book trading strategy. Further, complex trading strategies often involve numerous long and short positions in different products, so that those positions reflect a trading position that is different from its individual components (for example, box spreads, conversions, and reversals). FASB ASC 940-320-45-6

further states that for those activities, the resulting income and expense may be reflected net in the income statement, with disclosure of the gross components either on the face of the income statement or in the notes to the financial statements.

Costs Associated With Exit or Disposal Activities

7.113 FASB ASC 420, *Exit or Disposal Cost Obligations*, provides guidance on accounting and reporting for costs associated with exit or disposal activities, such as during a restructuring. Examples of costs include, but are not limited to, costs to consolidate or close facilities and to relocate employees and costs to terminate a contract that is not a capital lease. Appropriate disclosure of any exit or disposal activity should be in the notes to the financial statements and the financial effects should be disclosed in the financial statements as required by FASB ASC 420-10-50.

Appendix A

Auditor's Standard Report

The following is an illustration of an auditor's report that expresses an unqualified opinion on the financial statements and on the supplementary schedules required by the Securities and Exchange Commission.

Independent Auditor's Report

Board of Directors
Standard Stockbrokerage Co., Inc.:

We have audited the accompanying [*consolidated*] statement of financial condition of Standard Stockbrokerage Co., Inc., [*and Subsidiaries*] (the Company) as of December 31, 20X1, and the related [*consolidated*] statements of income, changes in stockholders' equity, changes in liabilities subordinated to claims of general creditors, and cash flows for the year then ended that you are filing pursuant to Rule 17a-5 under the Securities Exchange Act of 1934. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America.[1] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no*

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[1] For audits conducted in accordance with Public Company Accounting Oversight Board (PCAOB) standards, PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (AICPA, *PCAOB Standards and Related Rules*, Standards, AU-P app. A), replaces this sentence with the following sentence: "We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States)." On May 14, 2004, the Securities and Exchange Commission (SEC) issued an interpretive release to help with the implementation of PCAOB Auditing Standard No. 1 (AU-P app. A). See Release No. 33-8422 for more information. The release specifies that effective May 14, 2004, references in SEC rules and staff guidance and in the federal securities laws to generally accepted auditing standards (GAAS) or to specific standards under GAAS, as they relate to issuers, should be understood to mean the standards of the PCAOB, plus any applicable rules of the SEC. The guidance in this release is applicable only to auditors' engagements that are governed by PCAOB rules. The PCAOB, for example, has not established particular auditing standards for nonissuer broker-dealers or investment advisers. This release is not applicable to such engagements and related filings.

The staff of the PCAOB published a series of questions and answers on PCAOB Auditing Standard No. 1 (AU-P app. A). See the PCAOB website at www.pcaob.org for more information.

In June 2004, the Auditing Standards Board (ASB) issued Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report of a Nonissuer," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .89–.92), which provides reporting guidance for audits of nonissuers. Interpretation No. 18 provides guidance on the appropriate referencing of PCAOB auditing standards in audit reports when an auditor is engaged to perform the audit in accordance with both GAAS and PCAOB auditing standards. The ASB also is revising AU section 508 in light of the International Auditing and Assurance Standards Board's recently exposed International Standard on Auditing *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements* and PCAOB Auditing Standard No. 1 (AU-P app. A). See the AICPA website at www.aicpa.org/Research/Standards/AuditAttest/Pages/audit%20and%20attest%20standards.aspx for more information.

such opinion.] [2] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.[3]

In our opinion, the [*consolidated*] financial statements referred to above present fairly, in all material respects, the financial position of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] as of December 31, 20X1, and the results of its [*their*] operations and its [*their*] cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by Rule 17a-5 under the Securities Exchange Act of 1934. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Accounting Firm
New York, New York
February 15, 20X2[4]

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[2] This optional wording may be added in accordance with Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of AU section 508 (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .85–.88), which provides reporting guidance for audits of nonissuers. Interpretation No. 17 addresses how auditors may expand their independent audit report to explain that their consideration of internal control was sufficient to provide the auditor sufficient understanding to plan the audit and determine the nature, timing and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. If this optional language is added, then the remainder of the paragraph should read as follows:

> An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

[3] See paragraphs 3.113–.119 in chapter 3, "Regulatory Considerations," for information on obtaining confidential treatment of the financial statements from the SEC and Commodity Futures Trading Commission.

[4] Paragraph .23 of AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), states that the auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. Among other things, sufficient appropriate audit evidence includes 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 it has taken responsibility for them.

Appendix B

Separate Report on Supplementary Schedules

It is also acceptable to present a separate auditor's report on the supplementary schedules as follows.

Independent Auditor's Report on Supplementary Information
Required by Rule 17a-5 of the Securities and Exchange Commission

Board of Directors
Standard Stockbrokerage Co., Inc.:

We have audited the accompanying [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] as of and for the year ended December 31, 20X1, and have issued our report thereon dated February 15, 20X2. Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by Rule 17a-5 under the Securities Exchange Act of 1934. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Accounting Firm
New York, New York
February 15, 20X2

Appendix C

Report on Internal Control Required by SEC Rule 17a-5(g)(1)[1]

The following is an illustration of the independent auditor's report on internal control required by Securities and Exchange Commission Rule 17a-5(g)(1). Wording in this example report is based upon the guidance in Statement on Auditing Standards No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), which is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.

> Board of Directors
> Standard Stockbrokerage Co., Inc.:
>
> In planning and performing our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company), as of and for the year ended December 31, 20X1, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the [*consolidated*] financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.
>
> Also, as required by Rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company, including consideration of control activities for safeguarding securities. This study included tests of compliance with such practices and procedures that we considered relevant to the objectives stated in Rule 17a-5(g), in the following:
>
> 1. Making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under Rule 17a-3(a)(11) and the reserve required by Rule 15c3-3(e)
> 2. Making the quarterly securities examinations, counts, verifications, and comparisons, and the recordation of differences required by Rule 17a-13
> 3. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System
> 4. Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3
>
> The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the

[1] For audits conducted in accordance with Public Company Accounting Oversight Board standards refer to footnote 1 in appendix A.

expected benefits and related costs of controls, and of the practices and procedures referred to in the preceding paragraph, and to assess whether those practices and procedures can be expected to achieve the SEC's previously mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control and the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

A *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 deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the company's financial statements will not be prevented or detected and corrected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first and second paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities that we consider to be material weaknesses, as defined previously.[2]

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[2] Paragraph .28 of AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1) notes that if significant deficiencies are identified, this paragraph may be modified by inserting, "However, we identified certain deficiencies in internal control that we consider to be significant deficiencies, and communicated them in writing to management and those charged with governance on [date]." Paragraph .25 of AU section 325 states that the auditor should not issue a written communication stating that no significant deficiencies were identified because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.

If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of this paragraph of the report should be modified as follows:

> However, we identified the following deficiencies in [*internal control or control activities for safeguarding securities*] that we consider to be material weaknesses, as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures performed in our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] as of and for the year ended December 31, 20X2, and this report does not affect our report thereon dated February 15, 20Y1. [*A description of the material weaknesses that have come to the auditor's attention and corrective action*.]

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the SEC to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures, as described in the second paragraph of this report, were adequate at December 31, 20X1, to meet the SEC's objectives.[3]

This report is intended solely for the information and use of the Board of Directors, management, the SEC, [*Designated self-regulatory organization*], and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 in their regulation of registered brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm
New York, New York
February 15, 20X2

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[3] Whenever inadequacies are described, the last sentence of this paragraph should be modified as per footnote 2. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period, unless management already has reported them to the Securities and Exchange Commission.

Appendix D

Report on Internal Control Required by SEC Rule 17a-5(g)(1) for a Broker-Dealer Claiming an Exemption From SEC Rule 15c3-3[1, 2]

The following is an illustration of an independent auditor's report on internal control of a broker-dealer claiming an exemption from Securities and Exchange Commission Rule 15c3-3. Wording in this example report is based on the guidance in Statement on Auditing Standards No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), which is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.

Board of Directors
Standard Stockbrokerage Co., Inc.:

In planning and performing our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company), as of and for the year ended December 31, 20X1, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the [*consolidated*] financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Also, as required by Rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company including consideration of control activities for safeguarding securities. This study included tests of such practices and procedures that we considered relevant to the objectives stated in Rule 17a-5(g) in making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under Rule 17a-3(a)(11) and for determining compliance with the exemptive provisions of Rule 15c3-3. Because the Company does not carry securities accounts for customers or perform custodial functions relating to customer securities, we did not review the practices and procedures followed by the Company in any of the following:

1. Making quarterly securities examinations, counts, verifications, and comparisons and recordation of differences required by Rule 17a-13
2. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System

[1] For audits conducted in accordance with Public Company Accounting Oversight Board standards, refer to footnote 1 in appendix A.

[2] There are different types of exemptions under Securities and Exchange Commission Rules 15c3-3-k(1), k(2)(i), and k(2)(ii). Other formats of this letter may be required depending on the type of the exemption claimed.

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls and of the practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the SEC's previously mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control and the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

A *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 deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the company's financial statements will not be prevented or detected and corrected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first and second paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities that we consider to be material weaknesses, as defined previously.[3]

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the SEC to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures, as described in the second paragraph

[3] See footnote 2 in appendix C.

of this report, were adequate at December 31, 20X1, to meet the SEC's objectives.[4]

This report is intended solely for the information and use of the Board of Directors, management, the SEC, [*Designated self-regulatory organization*], and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 in their regulation of registered brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm
New York, New York
February 15, 20X2

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[4] See footnote 3 in appendix C.

Appendix E

Letter to SEC When the Broker-Dealer Has Not Made the Required Notification

The following report is appropriate if the broker-dealer has not made the required notification of material inadequacy or if the auditor does not agree with the statements therein. Modification of this letter may be required based on the facts and circumstances of the particular situation.

Securities and Exchange Commission
Washington D.C., and [*Appropriate regional office*]
Designated Examining Authority

Dear Sirs:

Our most recent audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company), was as of December 31, 20X0, and for the year then ended, which we reported on under date of February 15, 20X1. We have not audited any financial statements of the Company as of any date or for any period subsequent to December 31, 20X0. Although we are presently performing certain procedures as part of our audit of the [*consolidated*] financial statements of the Company as of December 31, 20X1, and for the year then ending, these procedures do not constitute all the procedures necessary in an audit conducted in accordance with auditing standards generally accepted in the United States of America or all the procedures necessary to (1) consider the Company's internal control as required by generally accepted auditing standards or (2) study the Company's practices and procedures relevant to the objectives stated in Rule 17a-5(g) of the Securities and Exchange Commission as required by Rule 17a-5.

The management of the Company is responsible for establishing and maintaining internal control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls. The objectives of internal control are to provide management with reasonable but not absolute assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and are recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles.

Because of inherent limitations in internal control, error or fraud may occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the effectiveness of the design and operation of controls may deteriorate.

The purpose of performing certain procedures prior to the date of the financial statements is to facilitate the expression of an opinion on the Company's financial statements. It must be understood that the procedures performed would not necessarily identify all material weaknesses in internal control and control activities for safeguarding securities.

However, pursuant to the requirements of Rule 17a-5(h)(2), we are to call to the attention of the chief financial officer any weaknesses that we believe to be material and that were disclosed during the course of interim work. We have made such notification to the chief financial officer of Standard Stockbrokerage Co., Inc., and we believe the following additional information is required pursuant to the requirements of the rule.

[*List and describe all instances where the independent auditor did not agree with the notification of the broker or dealer or where the required notification was not made.*]

Accounting Firm
New York, New York
December 10, 20X1

Appendix F

Report on Internal Control Required by CFTC Regulation 1.16 and SEC Rule 17a-5(g)(1)[1]

The following is an illustration of the independent auditor's report on internal control required by Commodity Futures Trading Commission Regulation 1.16 and Securities and Exchange Commission Rule 17a-5(g)(1). Wording in this example report is based on the guidance in Statement on Auditing Standards No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), which is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.

Board of Directors
Standard Stockbrokerage Co., Inc.:

In planning and performing our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company) as of and for the year ended December 31, 20X1, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the [*consolidated*] financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Also, as required by Rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company, including consideration of control activities for safeguarding securities. This study included tests of compliance with such practices and procedures that we considered relevant to the objectives stated in Rule 17a-5(g), in the following:

1. Making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under Rule 17a-3(a)(11) and the reserve required by Rule 15c3-3(e)
2. Making the quarterly securities examinations, counts, verifications, and comparisons, and the recordation of differences required by Rule 17a-13
3. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System
4. Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3

In addition, as required by Regulation 1.16 of the Commodity Futures Trading Commission (CFTC), we have made a study of the practices

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[1] For audits conducted in accordance with Public Company Accounting Oversight Board standards, refer to footnote 1 in appendix A.

and procedures followed by the Company including consideration of control activities for safeguarding customer and firm assets. This study included tests of such practices and procedures that we considered relevant to the objectives stated in Regulation 1.16, in making the following:

1. The periodic computations of minimum financial requirements pursuant to Regulation 1.17
2. The daily computations of the segregation requirements of Section 4d(a)(2) of the Commodity Exchange Act and the regulations thereunder, and the segregation of funds based on such computations
3. The daily computations of the foreign futures and foreign options secured amount requirements pursuant to Regulation 30.7 of the CFTC

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraphs. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls and of the practices and procedures referred to in the preceding paragraphs and to assess whether those practices and procedures can be expected to achieve the SEC's and the CFTC's previously mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) and Regulation 1.16(d)(2) list additional objectives of the practices and procedures listed in the preceding paragraphs.

Because of inherent limitations in internal control and the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

A *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 deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the company's financial statements will not be prevented or detected and corrected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first, second and third paragraphs and would not necessarily identify all deficiencies in internal control that might be material

weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities and certain regulated commodity customer and firm assets that we consider to be material weaknesses, as defined previously.[2]

We understand that practices and procedures that accomplish the objectives referred to in the second and third paragraphs of this report are considered by the SEC and CFTC to be adequate for their purposes in accordance with the Securities Exchange Act of 1934, the Commodity Exchange Act, and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures, as described in the second and third paragraphs of this report, were adequate at December 31, 20X1, to meet the SEC's and CFTC's objectives.[3]

This report is intended solely for the information and use of the Board of Directors, management, the SEC, the CFTC, [*Designated Self-Regulatory Organization*] and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 or Regulation 1.16 of the CFTC or both in their regulation of registered broker-dealers and futures commission merchants, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm
New York, New York
February 15, 20X2

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[2] See footnote 2 in appendix C.

[3] Whenever inadequacies are described, the last sentence of this paragraph should be modified as per footnote 2 in appendix C. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period, unless management already has reported them to the Securities and Exchange Commission and the Commodity Futures Trading Commission.

Appendix G

Independent Accountants' Report on Applying Agreed-Upon Procedures Related to an Entity's SIPC Assessment Reconciliation[1]

The following is an illustration of the independent accountant's report related to the entity's Securities Investor Protection Corporation (SIPC) assessment reconciliation as required under Securities and Exchange Commission (SEC) Rule 17a-5(e)(4).

To the Board of Directors of Standard Stockbrokerage Co., Inc.
[*Address*]
[*City, State*]

In accordance with Rule 17a-5(e)(4) under the Securities Exchange Act of 1934, we have performed the procedures enumerated below with respect to the accompanying Schedule of Assessment and Payments [General Assessment Reconciliation (Form SIPC-7)] to the Securities Investor Protection Corporation (SIPC) for the year ended December 31, 20X1, which were agreed to by Standard Stockbrokerage Co., Inc. and the Securities and Exchange Commission, Financial Industry Regulatory Authority, Inc., SIPC and [other designated examining authority or *specified parties of report*], solely to assist you and the other specified parties in evaluating Standard Stockbrokerage Co., Inc.'s compliance with the applicable instructions of the General Assessment Reconciliation (Form SIPC-7). Standard Stockbrokerage Co., Inc.'s management is responsible for the Standard Stockbrokerage Co., Inc.'s compliance with those requirements. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose. The procedures we performed and our findings are as follows:

1. Compared the listed assessment payments in Form SIPC-7 with respective cash disbursement records entries [*Insert description of disbursement records*] noting no differences;[2]

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[1] Securities and Exchange Commission Rule 17a-5(e)(4) states that a broker or dealer should file a supplemental report that covers the Securities Investor Protection Corporation (SIPC) annual general assessment reconciliation or exclusion from SIPC membership. At the issue date of this guide, an illustration of the report that covers an entity's exclusion from SIPC membership was being developed. When the illustrative report is available, it will be posted on the AICPA website at the Stockbrokerage and Investment Banking expert panel section at www.aicpa.org/INTERESTAREAS/ACCOUNTINGANDAUDITING/COMMUNITY/INVESTMENTBANKING/Pages/StockbrokerageInvestmentBanking.aspx.

[2] To the extent any differences are noted in any of the procedures, such differences will be disclosed as a finding.

2. Compared the amounts reported on the audited Form X-17A-5 for the year ended December 31, 20X1, as applicable, with the amounts reported in Form SIPC-7 for the year ended December 31, 20X1, noting no differences;
3. Compared any adjustments reported in Form SIPC-7 with supporting schedules and working papers [*Insert description of supporting schedules and working papers*] noting no differences;
4. Proved the arithmetical accuracy of the calculations reflected in Form SIPC-7 and in the related schedules and working papers [*Insert description of supporting schedules and working papers*] supporting the adjustments noting no differences; and
5. Compared the amount of any overpayment applied to the current assessment with the Form SIPC-7T on which it was originally computed noting no differences [*if applicable*].

We were not engaged to, and did not conduct an examination, the objective of which would be the expression of an opinion on compliance. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the specified parties listed above and is not intended to be and should not be used by anyone other than these specified parties.

February 15, 20X2

Appendix H

Representation Letter

[*Date of Auditor's Report*]

To [*Independent Auditor*]

We are providing this letter in connection with your audit of the [*consolidated*] statement of financial condition and the related [*consolidated*] statements of income, changes in stockholders' equity, changes in liabilities subordinated to claims of general creditors, and cash flows of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company) as of December 31, 20X1,[1] and for the year then ended, for the purpose of expressing an opinion as to whether the [*consolidated*] financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the Company in conformity with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation in the [*consolidated*] financial statements of financial condition, results of operations, and cash flows in conformity with generally accepted accounting principles.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief [*as of (date of auditor's report)*], the following representations made to you during your audit.

1. The [*consolidated*] financial statements referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America and include all disclosures necessary for such fair presentation otherwise required to be included by the laws and regulations to which the Company is subject.
2. We have made available to you all of the following:
   a. Financial records and related data.
   b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared. The most recent meetings held were: [*state by group and date*].
3. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
4. There are no material transactions that have not been properly recorded in the accounting records underlying the [*consolidated*] financial statements.

[1] Note that AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), requires the auditor to obtain written representations from management for all financial statements and periods covered by the auditor's report.

5. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the [*consolidated*] financial statements taken as a whole.[2]
6. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
7. We have no knowledge of any fraud or suspected fraud affecting the Company involving
   a. management,
   b. employees who have significant roles in internal control, or
   c. others where the fraud could have a material effect on the [*consolidated*] financial statements.
8. We have no knowledge of any allegations of fraud or suspected fraud affecting the Company received in communications from employees, former employees, analysts, regulators, short sellers, or others.
9. The Company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
10. The following have been properly recorded or disclosed in the [*consolidated*] financial statements:
    a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
    b. Guarantees, whether written or oral, under which the Company is contingently liable.
    c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 275, *Risks and Uncertainties*.
    d. Arrangements with financial institutions involving compensating balance arrangements involving restrictions on cash balances and lines of credit, or similar arrangements.
    e. The following information about financial instruments with off-balance-sheet risk and financial instruments [including receivables] with concentrations of credit risk:
       (1) The extent, nature, and terms of financial instruments with off-balance-sheet risk
       (2) The amount of credit risk of financial instruments with off-balance-sheet risk and information about the collateral supporting such financial instruments

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[2] If management believes that certain of the identified items are not misstatements, management's belief may be acknowledged by adding to the representation, for example, "We do not agree that items XX and XX constitute misstatements because [*description of reasons here*]." Also, a summary of the uncorrected misstatements should be included in or attached to the representation letter.

(3) Significant concentrations of credit risk arising from all financial instruments and information about the collateral supporting such financial instruments

f. Agreements to repurchase assets previously sold or resell assets previously purchased.

11. There are no

a. violations or possible violations of laws or regulations whose effects should be considered for disclosure in the [*consolidated*] financial statements or as a basis for recording a loss contingency.

b. unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with FASB ASC 450, *Contingencies*.[3]

c. other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB ASC 450.

12. The Company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral, except as disclosed in the [*consolidated*] financial statements.

13. The Company has complied with all aspects of contractual agreements that would have a material effect on the [*consolidated*] financial statements in the event of noncompliance.

14. Customers' debit balances, brokers' debit balances, and other accounts receivable are valid receivables. In our opinion, an adequate reserve has been established to cover any losses that may be incurred upon collection.

15. Provision has been made for any material loss to be sustained in the fulfillment of or from the inability to fulfill any purchase or sales commitments.

16. There are no securities or investments not readily marketable owned by the Company or borrowed under subordination agreements except as disclosed in the [*consolidated*] financial statements or notes thereto or as follows.

It is understood that the term "securities and investments not readily marketable" includes but is not limited to the following:

a. Securities for which there is no market on a securities exchange or independent publicly quoted market

b. Securities that cannot be publicly offered or sold unless registration has been effected under the Securities Act of 1933 (or the conditions of an exemption such as Regulation A under Section 3(B) of such act have been complied with), that is, restricted stock

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[3] In the circumstance discussed in footnote 11 of AU section 333, this representation might be worded as follows:

> We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the [*consolidated*] financial statements in accordance with Financial Accounting Standards Board *Accounting Standards Codification* 450, *Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

c. Securities and investments that cannot be offered or sold because of other arrangements, restrictions, or conditions applicable to the securities and investments or to the Company (that is, control stock)

17. The methods and significant assumptions used to determine fair values of financial instruments, including derivative product transactions, are as follows: [*Describe methods and significant assumptions used to determine fair value appropriate for financial statement measurement and disclosure purposes*.]

18. In addition, the Company at December 31, 20X1, had

    a. recorded all securities exchange memberships on the books.

    b. properly recorded all participation in joint accounts carried by others.

    c. no material unrecorded assets or contingent assets, such as claims relating to buy-ins, unfulfilled contracts, and so forth, whose value depends on the fulfillment of conditions regarded as uncertain.

    d. no open contractual commitments other than those appearing on the memo books and records; for example, when-distributed and delayed delivery contracts, underwritings and when-issued contracts, endorsements of puts and calls, and commitments in foreign currencies and spot (cash) commodity contracts.

    e. established a reserve for dividends and transfer items and security differences that is adequate to cover any anticipated losses in connection with the short securities that may have to be covered or claims arising from the liquidation of long securities.

    f. no borrowings or claims unconditionally subordinated to all claims or general creditors pursuant to a written agreement except as disclosed in the [*consolidated*] financial statements or notes thereto.

19. All liabilities subordinated to the claims of general creditors are covered by satisfactory subordination agreements under 17 CFR 240.15c3-1 (The Net Capital Rule) and approved by [*Examining authority*].

20. In accordance with FASB ASC 820, *Fair Value Measurements and Disclosures*, the Company has categorized its financial instruments, based on the priority of inputs to the valuation technique, into a three-level fair value hierarchy. The fair value gives the highest priority to quoted prices in active markets for identical assets or liabilities (level 1) and the lowest priority to unobservable inputs (level 3). If the inputs used to measure the financial instruments fall within different levels of the hierarchy, the categorization is based on the lowest level input that is significant to the fair value measurement of the instrument.

21. The Company has assessed the impact of FASB ASC 740, *Income Taxes*, and has determined that no material liability is required to be recorded.

22. Note X to the [*consolidated*] financial statements discloses all of the facts (meaning, significant conditions and events and management plans) of which we are aware that are relevant to the Company's ability to continue as a going concern.

23. Risks associated with concentrations, based on information known to management, that meet all of the following criteria have been disclosed in the [*consolidated*] financial statements:

    a. The concentration exists at the date of the [*consolidated*] financial statements.

    b. The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.

    c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

24. There are no capital withdrawals anticipated within the next six months other than as disclosed in the [*consolidated*] financial statements or notes thereto except as follows [*list any such items*].

25. There are no significant deficiencies or material weaknesses or material inadequacies at December 31, 20X1, or during the period January 1, 20X1, to the date of the auditor's report, in internal control over financial reporting and control activities for safeguarding securities, and the practices and procedures followed in

    a. making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital as defined in accordance with the Net Capital Rule and the customer reserve computations required by paragraph (e) of 17 CFR 240.15c3-3(e) (The Customer Protection Rule).

    b. making the quarterly securities examinations, counts, verifications and comparisons, and the recordation of differences required by 17 CFR 240.17a-13.

    c. complying with the requirement for prompt payment for securities under Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System.

    d. obtaining and maintaining physical possession or control of all fully paid and excess-margin securities of customers as required by The Customer Protection Rule.

    e. making periodic computations of the minimum financial requirements pursuant to Regulation 1.17 of the Commodity Exchange Act.

    f. making daily computations of the segregation requirements of Section 4d(2) (and Regulation 30) of the Commodity Exchange Act and the regulations thereunder, and the segregation of funds based upon such computations.

26. Net capital computations, prepared by the Company during the period from January 1, 20X1, through the date of the auditor's report,

indicated that the Company was in compliance with the requirements of The Net Capital Rule (and applicable exchange requirements) at all times during the period. Customer reserve computations pursuant to the Customer Protection Rule during the period did not reveal any deposit requirements that were not made on a timely basis.

27. There was no computation of segregation requirements under the Commodity Exchange Act that indicated an insufficiency in segregation during the period from January 1, 20X1 through the date of the auditor's report.
28. The Company has appropriately reconciled its books and records (for example, general ledger accounts) underlying the [*consolidated*] financial statements to their related supporting information (for example, sub ledger or third-party data). All related reconciling items considered to be material were identified and included on the reconciliations and were appropriately adjusted in the [*consolidated*] financial statements. There were no material unreconciled differences or general ledger suspense account items that should have been adjusted or reclassified to another account. [*All consolidating entries have been properly recorded.*] All intracompany and [*intercompany*] accounts have been eliminated or appropriately measured and considered for disclosure in the [*consolidated*] financial statements.
29. Foreign and domestic operating subsidiaries of the Company which are subject to local securities and capital adequacy requirements were in compliance with such regulations and requirements at December 31, 20X1, and for the year then ended.
30. All borrowings and financial obligations of the Company of which we are aware are included in the [*consolidated*] financial statements at December 31, 20X1, as appropriate. We have fully disclosed to you all borrowing arrangements of which we are aware.

To the best of our knowledge and belief, no events have occurred subsequent to the statement of financial condition date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

____

[*Name of Chief Executive Officer and Title*]

____

[*Name of Chief Financial Officer and Title*]

For publicly held broker dealers that include certifications of the Chief Executive Officer and Chief Financial Officer when filing with the Securities and Exchange Commission, the individuals certifying in those capacities should also sign the representation letter in order to directly confirm and document the communications to auditors described in their certifications (see paragraphs 5.131–.132). Other officers who provide material representations during the audit should also be considered for inclusion as signers.

Appendix I

Agreed-Upon Procedures

[*Date*]

To the Board of Directors
Standard Stockbrokerage Co., Inc.:

We have performed the procedures enumerated below, which were agreed to by the Standard Stockbrokerage Co., Inc. (the Company) and [*Name of government sponsored entity*] (the Agency), solely to assist the specified parties in evaluating the Company's compliance with Section(s) of the Agency's Selling Group Agreement dated [*Date*] (the Agreement), entitled [*Title*], and Section(s) entitled [*Title*] of the Guidelines to the Agreement (collectively, the Agreements and Procedures), during the period [*Define period*] (the Period). Management is responsible for the Company's compliance with those requirements. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report was requested or for any other purpose.

The procedures we have performed are as follows.

1. Read the Agreement(s) and Procedure(s).

2. Obtained written representation from management of the Company stating that: (1) the Company complied with the provisions of the Agreement(s) and Procedure(s) for the Period; (2) all records maintained pursuant to the Agreement(s) are retained in accordance with the record-keeping provisions of the Agreement(s) and Procedure(s); (3) all required offering documentation had been sent to investors during the Period in accordance with the Agreement(s); and (4) for any affiliates, domestic or foreign, through which primary [*Agency*] securities were distributed to customers, the compliance standards maintained were also met by the affiliates; additionally, any affiliates not meeting such standards were excluded from participating in primary distribution of [*Agency*] securities.

3. Read the Company's trading and selling policies and procedures related to the Agreements noted above as furnished to us by the Company. [*If policies and procedures are not documented in writing, the accountant should so indicate*.]

4. Based on our reading of the above-mentioned trading and selling policies and procedures, noted that the traders and salespeople (including salespeople in domestic and foreign affiliates which operate as broker-dealers for Agency primary issuance) involved in the offering and sale of Agency Securities are required to read and be familiar with the Agreement(s) and the Company's written procedures covering the offering and sale of Agency Securities.

5. Inquired of the designated individuals within the Company responsible for monitoring compliance with the Agreement(s) and Procedure(s) as to whether there are any written reports prepared during

the Period relative to the Company's compliance with the Agreement and the Guidelines for the Agreement(s) and Procedure(s).

6. Obtained and read the report(s) noted in step 5 above (if applicable) and have confirmed that the reports did not contain any findings that would be deemed to be in non-compliance with the Agreement(s) and Procedure(s).

7. Obtained from the Company a list of all issues and the total allotment for which the Company has acted as a selling group member during the Period (see appendix J, "Agency Issues Participation Listing"). The Company has represented to us that such list is complete and accurate. The listings were compared to the detail supplied by the Agency. Please note that certain agencies, for example, the Federal National Mortgage Association (FNMA or Fannie Mae) may provide the independent auditor with this list. When provided, this list should be utilized in performing all related procedures.

8. Requested and obtained the Distribution Reports, Securities Industry and Financial Markets Association (SIFMA) Prepricing Reports or substantially similar reports that include all the information that is contained in a SIFMA Prepricing Report (Prepricing Reports), trade tickets, and general ledger account detail from Company personnel for a sample of issues [*state number of issues*] referred to in step 7 above. Please note the following:

   a. All other relevant trading account records will be requested and report names and terminology may vary.

   b. The Company should confer with each Agency to determine the appropriate number of issues for selection purposes.

   c. Certain agencies will provide the independent auditor with copies of Distribution Reports (for example, Fannie Mae). In these instances, the reports and the complete list of issues (described in step 7 above) received from the Agency should be used to perform this step.

9. Performed the following procedures with respect to the Distribution Reports for issues selected in step 8 above.

   a. Read the Distribution Reports and noted signatures; Company representatives indicated that individuals who signed the Distribution Reports were authorized persons pursuant to Section [*Number*] of the Agreement.

   b. Compared and agreed the number of transactions, amount, and classification [*Municipal organization, corporation, brokers, etc.*] of all sales to customers, before when-issued trading, and total allotment from the Distribution Reports to the Prepricing Reports.

   c. Recomputed the mathematical accuracy of all totals on the Distribution Reports.

10. Performed the following procedures with respect to the Prepricing Reports for issues as obtained in step 8.

    a. Selected haphazardly [*Number*] orders for each sample issue selected in step 8.

    b. For all orders selected in step a above, verified information accuracy by utilizing internal records or sent confirmation requests to confirm the amount, price, type of order, type of customer, trade date and other specified conditions of the order (for example, limit order). All orders selected must be validated via the described procedures or alternative procedures. Less than 100% compliance should be noted as an exception. [*Please note that the number and minimum confirm response rate should be determined by the Company in conjunction with the Agency. Confirmation results should be summarized and the nature of exceptions, if any, should be described either in the body of the report or in a separate attachment.*] See appendix K, "Confirmation Statistics," for a summary of confirmations.

    c. For all orders selected in step 10*a* above, compared and agreed individual orders and amounts to the related trade tickets and general ledger account detail.

    d. Read each Prepricing Report for the applicable issues identified in step 8 above, noting that total allotment and order conditionality were noted on such report.

    e. For all orders selected in step 10*a* above, read the trade tickets, noting that the sales prices were at face value or at prices offered to the public as published by the Agency.

    f. For [*Number*] transactions haphazardly selected from the Prepricing Reports obtained in step 8 above, we obtained from representatives of the Company the names of the sales person(s) (institutional or retail) who were involved in the transactions, and obtained documentation as provided by the Company indicating that such individuals have received training, as defined in the Agreement(s). Such documentation consists of [*Describe*].

11. [*For purchases and sales from or to other members of the Agency Bond Selling Group (Reallowance Orders), if any, prior to the time that the securities are free to trade on the offering date, the Company is required to receive express authorization or specific permission from the Agency for such purchases and sales from the Agency for Reallowance Orders for such issue. Please note that authorization is not required for all reallowance orders. Certain reallowance orders are permitted under the Agreement. The Company should read the Agreement and contact the Agency for purposes of identifying such orders.*] Attached is a list in appendix L, "List of Reallowance Orders," of all reallowance orders for which authorization is required as represented to us by the Company.

12. [*For all orders for the account of an affiliate of the Company or for another nonaffiliated dealer who is not a member of the Agency Selling Group that are purchasing the securities, the Company must specifically advise the Agency of such orders.*] Compared the principal amount and trade date for such purchases as provided to us by representatives of the Company from the trade tickets to the corresponding data reflected in the notification to the Agency as provided by the Company, and found them to be in agreement.
13. For all participating programs, reviewed the Company's policies and procedures relative to the process of identifying, initiating, tracking, recording and sending of the required offering documentation. For the items selected above, ensured the customers received offering documentation (as an alternative procedure, customer confirmations can be sent). [*Any exceptions should be provided in an attachment.*]

We were not engaged to, and did not conduct an examination, the objective of which would be the expression of an opinion on compliance. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of Standard Stockbrokerage Co., Inc. and [*Name of specified government sponsored entity using the report*] and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm
New York, New York
May 15, 20XX

Note: The agreed-upon procedures report suggests certain procedures that the independent auditor should perform. Please note the Company may request its independent auditor to perform other procedures. Such additional procedures should be performed to satisfy other specific requirements of certain government agencies and the Company should consult with the agencies in determining such procedures.

Appendix J

Agency Issues Participation Listing

Standard Stockbrokerage Co., Inc.

Agency Issues Participation Listing[1]

For the Period __ to __

CUSIP Number	*Total Allotment*	*Reported Sales Per Prepricing Report[2]*	*Actual Sales Per Distribution Report[2]*	*Offering Documentation Delivered to Customers[3] Yes/No*

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[1] Certain agencies may incorporate the contents of this appendix into the agreed-upon procedures report.

[2] Information should be provided for issues selected for testing.

[3] If offering documentation is not delivered, please indicate specific reasons.

Appendix K

Confirmation Statistics

Standard Stockbrokerage Co., Inc.

Confirmation Statistics[1]

[March 15, 20XX] Offering

Confirmations—Orders[2]		
Total number of orders	[#]	$[*Amount*]
Orders confirmed	[#]	$[*Amount*]
Confirmations returned without exception	[#]	$[*Amount*]
Confirmations returned with exception	[#]	$[*Amount*]
Confirmation exceptions cleared	[#]	$[*Amount*]
Alternative procedures performed	[#]	$[*Amount*]
Coverage[3] (based on number of confirmations mailed)	[%]	

[April 30, 20XX] Offering

Confirmations—Orders[2]		
Total number of orders	[#]	$[Amount]
Orders confirmed	[#]	$[*Amount*]
Confirmations returned without exception	[#]	$[*Amount*]
Confirmations returned with exception	[#]	$[*Amount*]
Confirmation exceptions cleared	[#]	$[*Amount*]
Alternative procedures performed	[#]	$[*Amount*]
Coverage[3] (based on number of confirmations mailed)	[%]	

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[1] Certain agencies may incorporate the contents of this appendix into the agreed-upon procedures report.

[2] Orders include filled, partially filled, not filled or canceled orders.

[3] If the minimum response rate is not obtained as determined in step 10*a* of the report, two follow-up requests, either written or oral, should be performed. Further, if the minimum response rate is not obtained through follow-up requests, alternative procedures should be performed and described in the body of the report or in a separate attachment.

Appendix L

List of Reallowance Orders

Standard Stockbrokerage Co., Inc.

List of Reallowance Orders[1]

[March 15, 20XX] Offering

Date	*Description of Security*	*Quantity Re-allowed*	*Purchase Amount*	*Sell Amount*

[April 30, 20XX] Offering

Date	*Description of Security*	*Quantity Re-allowed*	*Purchase Amount*	*Sell Amount*

---

[1] Certain agencies may incorporate the contents of this appendix into the agreed-upon procedures report.

Appendix M

Information Sources

Further information on matters addressed in this guide is available through various publications and services listed in the table that follows. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Electronic bulletin board services allow users to read, copy, and exchange information electronically. Most are available using a modem and standard communications software. Some bulletin board services are also available using one or more Internet protocols.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

Information Sources

Organization	General Information	Fax	Website Address/ Electronic Bulletin Board	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* 220 Leigh Farm Rd. Durham, NC 27707-8110 (888) 777-7077 If outside of the U.S., call (919) 402-4500	*24 Hour Fax Hotline* (800) 362-5066	www.aicpa.org	
Financial Accounting Standards Board	*Order Department* 401 Merritt 7, P.O. Box 5116 Norwalk, CT 06856-5116 (800) 748-0659		www.fasb.org	
U.S. Securities and Exchange Commission	100 F Street, NE Washington, DC 20549 *Publications Unit* (202) 551-4040 *SEC Public Reference Room* (202) 551-8090		www.sec.gov	*Information Line* (888) SEC-6585
Securities Industry and Financial Markets Association	120 Broadway, 35th FL New York, NY 10271-0080 (212) 313-1200	(212) 313-1301	www.sifma.org	
NYSE Euronext (formerly New York Stock Exchange, Inc.)	11 Wall Street New York, NY 10005 (212) 656-3000		www.nyse.com	

Information Sources—continued

Organization	General Information	Fax	Website Address/ Electronic Bulletin Board	Recorded Announcements
Financial Industry Regulatory Authority (FINRA) (formerly National Association of Securities Dealers, Inc.)	1735 K Street Washington, DC 20006 (301) 590-6500		www.finra.org	
Commodity Futures Trading Commission	Three Lafayette Center 1155 21st Street, NW Washington, DC 20581 General number (202) 418-5000	(202) 418-5521	www.cftc.gov	
Futures Industry Association	2001 Pennsylvania Avenue, NW Suite 600 Washington, DC 20006-1807 (202) 466-5460	(202) 296-3184	www.futuresindustry.org	
National Futures Association	300 S. Riverside Plaza #1800 Chicago, IL 60606-6615 Main number (312) 781-1300 *Information Center* (312) 781-1410 or (800) 621-3570	(312) 781-1467	www.nfa.futures.org	

Appendix N

International Financial Reporting Standards

Note: The following content may include certain changes made since the original print version of the guide.

Introduction

The following information provides a brief overview of the ongoing globalization of accounting standards, International Financial Reporting Standards (IFRSs) as a body of accounting literature, the status of convergence with IFRSs in the United States, and the related issues that accounting professionals need to consider today.

Globalization of Accounting Standards

As the business world becomes more globally connected, regulators, investors, audit firms, and public and private companies of all sizes are expressing an increased interest in having common accounting standards among participants in capital markets and trading partners around the world. Proponents of convergence with, or adoption of, IFRSs for financial reporting in the United States believe that one set of financial reporting standards would improve the quality and comparability of investor information and promote fair, orderly, and efficient markets.

Many critics, however, believe that U.S. generally accepted accounting principles (GAAP) are the superior standards and question whether the use of IFRSs will result in more useful financial statements in the long term and whether the cost of implementing IFRSs will outweigh the benefits. Implementing IFRSs will require a staggering effort by management, auditors, and financial statement users, not to mention educators.

The increasing acceptance of IFRSs, both in the United States and around the world, means that now is the time to become knowledgeable about these changes. The discussion that follows explains the underpinnings of the international support for a common set of high quality global standards and many of the challenges and potential opportunities associated with such a fundamental shift in financial accounting and reporting.

The international standard setting process began several decades ago as an effort by industrialized nations to create standards that could be used by developing and smaller nations. However, as cross-border transactions and globalization increased, other nations began to take interest, and the global reach of IFRSs expanded. Nearly 117 nations and reporting jurisdictions permit or require IFRSs for domestic listed companies (approximately 90 countries have fully conformed to IFRSs as promulgated by the International Accounting Standards Board [IASB] and include a statement acknowledging such conformity in audit reports). Other countries, including Canada and India, are expected to transition to IFRSs by, or beginning in, 2011. Mexico plans to adopt IFRSs for all listed companies starting in 2012. Other countries have plans to

converge (or eliminate significant differences between) their national standards and IFRSs.

For many years, the United States has been a strong leader in international efforts to develop globally accepted standards. Among other actions in support of IFRSs, the U.S. Securities and Exchange Commission (SEC) removed the requirement for foreign private issuers registered in the United States to reconcile their financial reports with U.S. GAAP if their accounts complied with IFRSs as issued by the IASB. In addition, the SEC continues to analyze and evaluate appropriate steps toward, and challenges related to, converging U.S. GAAP with IFRSs, as subsequently described.

In addition to the support received from certain U.S. based entities, financial and economic leaders from various organizations have announced their support for global accounting standards. Most notably, in 2009, the Group of Twenty Finance Ministers and Central Bank Governors (G20), a group from 20 of the world's systematically important industrialized and developing economies (with the 20th member being the European Union, collectively), called for standard setters to redouble their efforts to complete convergence in global accounting standards.

Acceptance of a single set of high quality accounting standards may present many significant opportunities, including the improvement in financial reporting to global investors, the facilitation of cross-border investments, and the integration of capital markets. Further, U.S. entities with international operations could realize significant cost savings from the use of a single set of financial reporting standards. For example, U.S. issuers raising capital outside the United States are required to comply with the domestic reporting standards of the foreign country and U.S. GAAP. As a result, additional costs arise from the duplication and translation of financial reporting information.

Many multinational companies support the use of common accounting standards to increase comparability of financial results among reporting entities from different countries. They believe common standards will help investors better understand the entities' business activities and financial position. Large public companies with subsidiaries in multiple jurisdictions would be able to use one accounting language company-wide and present their financial statements in the same language as their competitors. In addition, some believe that in a truly global economy, financial professionals, including CPAs, will be more mobile, and companies will more easily be able to respond to the human capital needs of their subsidiaries around the world.

Although certain cost reductions are expected, the initial cost of convergence with IFRSs is expected to be one of the largest obstacles for many entities, including accounting firms and educational institutions. Substantial internal costs for U.S. corporations in the areas of employee training, IT conversions, and general ledger software have been predicted. In addition, the time and effort required from various external functions, including the education of auditors, investors, lenders, and other financial statement users, will be significant factors for consideration.

Although the likelihood of acceptance of IFRSs may lack clarity for the time being, U.S. companies should consider preparing for the costly transition to new or converged standards, which likely will include higher costs in the areas of training and software compliance.

Who is the IASB?

The IASB is the independent standard setting body of the IFRS Foundation, formerly, the International Accounting Standards Committee Foundation. As a private sector organization, the IFRS Foundation has no authority to impose funding regimes on countries. However, a levy system and national contributions through regulatory and standard-setting authorities or stock exchanges have been introduced in a number of countries to fund the organization. Although the AICPA was a founding member of the International Accounting Standards Committee (IASC), the IASB's predecessor organization, it is not affiliated with the IASB.

The IASB, founded on April 1, 2001, in London, England, is responsible for developing IFRSs and promoting the use and application of these standards. In pursuit of this objective, the IASB cooperates with national accounting standard setters to achieve convergence in accounting standards around the world.

The structure includes the following primary groups: (*a*) the IFRS Foundation, an independent organization having two main bodies: the IFRS Foundation trustees and the IASB; (*b*) the IFRS Advisory Council; and (*c*) the IFRS Interpretations Committee, formerly the International Financial Reporting Interpretations Committee (IFRIC). The trustees appoint the IASB members, exercise oversight, and raise the funds needed, but the IASB itself has responsibility for establishing IFRSs.

The IASB board members are selected chiefly upon their professional competence and practical experience. The trustees are required to select members so that the IASB will comprise the best available combination of technical expertise and international business and market experience and to ensure that the IASB is not dominated by any particular geographical interest or constituency. The members of the IASB currently represent nine countries, including the United States. The members are responsible for the development and publication of IFRSs, including *International Financial Reporting Standard for Small- and Medium-sized Entities* (*IFRS for SMEs*), and for approving the interpretations of IFRSs as developed by the IFRS Interpretations Committee.

The IFRS Interpretations Committee, founded in March 2002, is the successor of the previous interpretations committee, the Standing Interpretations Committee (SIC), and is the interpretative body of the IASB. The role of the IFRS Interpretations Committee is to provide timely guidance on newly identified financial reporting issues not specifically addressed in IFRSs or issues in which interpretations are not sufficient.

IFRSs are developed through a formal system of due process and broad international consultation, similar to the development of U.S. GAAP.

Readers are encouraged to become involved in the standard-setting process by responding to open calls from the standard setting organizations.

What Are IFRSs?

The term *IFRSs* has both a narrow and broad meaning. Narrowly, IFRSs refers to the numbered series of pronouncements issued by the IASB, collectively

called *standards*. More broadly, however, IFRSs refer to the entire body of authoritative IASB literature, including the following:

- Standards, whether labeled IFRSs or International Accounting Standards (IASs)[1]
- Interpretations, whether labeled IFRIC (the former name of the interpretive body) or SIC (the predecessor to IFRIC)[2]

The preface to the IFRS 2010 Bound Volume states that IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities, including commercial, industrial, and financial entities, regardless of legal form or organization. IFRSs are not designed to apply to not-for-profit entities or those in the public sector,[3] but these entities may find IFRSs appropriate in accounting for their activities.

The IASB's *Framework for the Preparation and Presentation of Financial Statements* (IASB Framework) establishes the concepts that underlie the preparation and presentation of financial statements for external users. The IFRS Foundation is guided by the IASB Framework in the development of future standards and in its review of existing standards. The IASB Framework is not an IFRS, and when there is a conflict between the IASB Framework and any IFRS, the standard will prevail. The IASB Framework is an overall statement of guidance for those interpreting financial statements, whereas IFRSs are issue and subject specific.

When an IFRS specifically applies to a transaction, other event, or condition, the accounting policy or policies applied to that item shall be determined by applying the IFRS and considering any relevant implementation guidance issued by the IASB for the IFRS.

Further, if an IFRS does not address a specific transaction, event, or condition explicitly, IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, states that management should use its judgment in developing and applying an accounting policy that results in information that is relevant and reliable. With respect to the reliability of financial statements, IAS 8 states that the financial statements (*a*) represent faithfully the financial position, financial performance, and cash flows of the entity; (*b*) reflect the economic substance of transactions, other events, and conditions; (*c*) are neutral; (*d*) are prudent; and (*e*) are complete in all material respects. When making this type of judgment, management should refer to, and consider the applicability of, the following in descending order:

- The requirements and guidance in IFRSs dealing with similar and related issues
- The definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expenses in the IASB Framework

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[1] See www.iasb.org for a current listing of International Financial Reporting Standards (IFRSs) and International Accounting Standards (IASs).

[2] See www.iasb.org for a current listing of International Financial Reporting Interpretations Committee and Standing Interpretations Committee interpretations.

[3] Generally speaking, *public* means government-owned entities, and *private* means nongovernment-owned entities.

- The most recent pronouncements of other standard setting bodies (for example, U.S. GAAP, other accounting literature, and accepted industry practices) to the extent that these do not conflict with IFRSs

IFRS for SMEs

IFRS for SMEs is a modification and simplification of full IFRSs aimed at meeting the needs of private company financial reporting users and easing the financial reporting burden on private companies through a cost-benefit approach. *IFRS for SMEs* is a self-contained, global accounting and financial reporting standard applicable to the general purpose financial statements of entities that, in many countries, are known as small- and medium-sized entities (SMEs). Full IFRSs and *IFRS for SMEs* are promulgated by the IASB.

SMEs are entities that publish general purpose financial statements for external users and do not have public accountability. An entity has public accountability under the IASB's definition if it files its financial statements with a securities commission or other regulatory organization or it holds assets in a fiduciary capacity (for example, banks, insurance companies, brokers and dealers in securities, pension funds, and mutual funds). It is not the IASB's intention to exclude entities that hold assets in a fiduciary capacity for reasons incidental to their primary business (for example, travel agents, schools, and utilities) from utilizing *IFRS for SMEs*.

The needs of users of SME financial statements often are different from the needs of users of public company financial statements and other entities that likely would use full IFRSs. Whereas full IFRSs were designed specifically to meet the needs of equity investors in the public capital markets, *IFRS for SMEs* was developed with the needs of a wide range of users in mind. Users of the financial statements of SMEs may be more focused on shorter-term cash flows, liquidity, balance sheet strength, interest coverage, and solvency issues. Full IFRSs may impose a burden on SME preparers in that full IFRSs contain topics and detailed implementation guidance that generally are not relevant to SMEs. This burden has been growing as IFRSs have become more detailed. As such, a significant need existed for an accounting and financial reporting standard for SMEs that would meet the needs of their financial statement users while balancing the costs and benefits from a preparer perspective.

Practically speaking, *IFRS for SMEs* is viewed as an accounting framework for entities that do not have the capacity or resources to use full IFRSs. In the United States, the term SME would encompass many private companies.

In May 2008, the AICPA Governing Council voted to recognize the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles and amended appendix A, "Council Resolution Designating Bodies to Promulgate Technical Standards," of Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 202 par. .01), and Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, vol. 2, ET sec. 203 par. .01). This amendment gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. Accordingly, IFRSs are not considered to be an other comprehensive basis of accounting. Rather, they are a source of GAAP.

As such, a key professional barrier to using IFRSs and, therefore, *IFRS for SMEs*, has been removed. Any remaining barriers may come in the form of unwillingness by a private company's financial statement users to accept financial statements prepared under *IFRS for SMEs* and a private company's expenditure of money, time, and effort to convert to IFRS for SMEs.[4]

The AICPA has developed a resource that compares *IFRS for SMEs* with corresponding requirements of U.S. GAAP. This resource is available in a Wiki format, which allows AICPA members and others to contribute to its development. To learn more about the resource, view available sections, and contribute to its content, visit the Wiki at http://wiki.ifrs.com/.

The Financial Accounting Standards Board and IASB Convergence Efforts[5]

To address significant differences between IFRSs and U.S. GAAP, the Financial Accounting Standards Board (FASB) and the IASB agreed to a "Memorandum of Understanding" (MoU), which was originally issued in 2006 and subsequently updated. Readers are encouraged to monitor the FASB and IASB websites for additional developments regarding the convergence efforts, such as discussion papers, exposure drafts, and requests for comments.

Comparison of U.S. GAAP and IFRSs

One of the major differences between U.S. GAAP and IFRSs lies in the conceptual approach: U.S. GAAP is based on principles, with heavy use of rules to illustrate the principles; however, IFRSs are principles based, without heavy use of rules.

In general, a principles-based set of accounting standards, such as IFRSs, is broad in scope. The standards are concise, written in plain language, and provide for limited exceptions and bright lines. Principles-based standards typically require a higher level of professional judgment, which may facilitate an enhanced focus on the economic purpose of a company's transactions and how the transactions are reflected in its financial reporting.

A noticeable result of these differences is that IFRSs provide much less overall detail. In developing an IFRS, the IASB expects preparers to rely on core principles and limited application guidance with fewer prescriptive rules. In contrast, FASB often leans more toward providing extensive prescriptive guidance and detailed rules. The guidance provided in IFRSs regarding revenue recognition, for example, is significantly less extensive than U.S. GAAP. IFRSs also contain relatively little industry-specific guidance.

An inherent issue in a principles-based system is the potential for different interpretations of similar transactions across jurisdictions and entities, which may affect the relative comparability of financial reporting.

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[4] CPAs are encouraged to consult their state boards of accountancy to determine the status of reporting on financial statements prepared in accordance with *International Financial Reporting Standard for Small- and Medium-sized Entities* within their individual state.

[5] Because the convergence projects discussed are active and subject to change, updates will be posted periodically to www.journalofaccountancy.com. Readers also are encouraged to monitor the progress of these projects at the respective boards' websites: www.iasb.org and www.fasb.org.

Because of long-standing convergence projects between the IASB and FASB, the extent of the specific differences between IFRSs and U.S. GAAP is decreasing. Yet, significant differences remain, which could result in significantly different reported results, depending on a company's industry and individual facts and circumstances. For example, some differences include the following:

- IFRSs do not permit last in, first out (LIFO) inventory accounting.
- IFRSs allow for the revaluation of assets in certain circumstances.
- IFRSs use a single-step method for impairment write-downs rather than the two-step method used in U.S. GAAP, making write-downs more likely.
- IFRSs have a different probability threshold and measurement objective for contingencies.
- IFRSs generally do not allow net presentation for derivatives.

U.S. GAAP also addresses some specific transactions not currently addressed in IFRSs, such as accounting for reorganizations, including quasi reorganizations; troubled debt restructuring; spin-offs; and reverse spin-offs. In addition, U.S. GAAP is designed to apply to all nongovernmental entities, including not-for-profit entities, and includes specific guidance for not-for-profit entities, development stage entities, limited liability entities, and personal financial statements.

The difference in the amount of industry-specific guidance also illustrates the different approaches. Currently, IFRSs include only several standards (for example, IAS 41, *Agriculture*)[6] that might be regarded as primarily industry-specific guidance. However, the scope of these standards includes all entities to which the scope of IFRSs applies. In contrast, U.S. GAAP has considerable guidance for entities within specific industries. For example, on liability recognition and measurement alone, U.S. GAAP contains specific guidance for entities in the following industries, which is not found in IFRSs:

- Health care
- Contractors and construction
- Contractors and the federal government
- Entertainment, with separate guidance for casinos, films, and music
- Financial services, with separate guidance for brokers and dealers and depository and lending, insurance, and investment companies

For nonmonetary transactions, U.S. GAAP provides specific guidance for the airline, software, and entertainment industries.

SEC Work Plan

The SEC continues to affirm its support for a single set of high-quality, globally accepted accounting standards and for the convergence of U.S. GAAP and IFRSs. In February 2010, the SEC issued Release No. 33-9109, *Commission*

[6] In addition to IAS 41, *Agriculture*, the other IFRSs that address issues specific to certain industries are IFRS 4, *Insurance Contracts*, and IFRS 6, *Exploration for and Evaluation of Mineral Resources*.

Statement in Support of Convergence and Global Accounting Standards. This release provides an update to Release No. 33-8982, *Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers*. The February 2010 release provides a confirmation of the SEC's continued support for convergence, highlights positive aspects of narrowing the differences between the two sets of standards, and outlines additional considerations required before adoption of a single standard is achieved.

The release also states that a more comprehensive work plan is necessary to lay out the work required to support a decision on the appropriate course to incorporate IFRSs into the U.S. financial reporting system for U.S. issuers, including the scope, timeframe, and methodology for any such transition. The SEC has indicated that it will carefully consider and deliberate whether a potential transition is in the best interest of U.S. investors and markets.

By 2011, assuming completion of the convergence projects and the SEC staff's work plan, the SEC will decide whether to incorporate IFRSs into the U.S. financial reporting system and, if so, when and how. The work plan is included as an appendix at the end of the SEC's release, which is located on the SEC's website at www.sec.gov.

AICPA

On February 24, 2010, president and CEO of the AICPA Barry Melancon issued a statement on the SEC's plan to work toward the incorporation of IFRSs in the U.S. financial reporting system. The statement noted that the AICPA supports the thoughtful and concrete steps the SEC is taking, as outlined in its plan, to prepare for the transition. The AICPA understands that it will need to fulfill a number of responsibilities to make the use of IFRSs in the United States a success. Ongoing efforts include the following:

- Continuing to educate AICPA members about IFRSs
- Working with accounting educators, textbook authors, and educational institutions to prepare future professionals to use IFRSs
- Making certain the voice of U.S. CPAs is heard internationally
- Incorporating questions about IFRSs into the Uniform CPA Exam

The AICPA believes that it is critical for the SEC to set a specific date for the use of IFRSs in the United States and encourages the SEC, as it completes this work plan in 2011, to ensure investor confidence is maintained and key milestones lead successfully to global standards in 2015. In moving forward, it is essential that all stakeholders—regulators, investors, auditors, educators, financial statement users, and preparers—have the knowledge and tools they need to successfully navigate any change in U.S. accounting rules. The AICPA is doing its part now to prepare these stakeholders for this fundamental shift in financial reporting.

Additional Resources

Website	*URL*
AICPA	www.aicpa.org
AICPA International Financial Reporting Standards Resources	www.ifrs.com
International Accounting Standards Board	www.iasb.org
Comparison Wiki of *International Financial Reporting Standard for Small- and Medium-sized Entities* and U.S. generally accepted accounting principles	http://wiki.ifrs.com
Financial Accounting Standards Board	www.fasb.org

Appendix O

Schedule of Changes Made to the Text From the Previous Edition

As of July 1, 2010

This schedule of changes identifies areas in the text and footnotes of this guide that have changed since the previous edition. Entries in the table of this appendix reflect current numbering, lettering (including that in appendix names), and character designations that resulted from the renumbering or reordering that occurred in the updating of this guide.

Reference	*Change*
Preface	Updated.
Paragraphs 1.01 and 1.14	Revised for clarification.
Paragraphs 1.24 and 1.32	Revised for passage of time.
Footnote * in paragraph 1.47	Revised.
Paragraphs 1.50, 1.56, and 1.88	Revised for clarification.
Paragraphs 2.02, 2.13, and 2.25; footnote 1 in paragraph 2.35	Revised for the passage of time.
Footnote 2 in paragraph 2.36	Added for clarification.
Paragraph 2.67	Revised for clarification.
Former footnote * to heading before paragraph 2.95	Deleted.
Former footnote † to heading before paragraph 2.119	Deleted.
Footnote * to heading before paragraph 2.119; footnote † in paragraph 2.166	Added.
Footnote * to chapter 3 title	Added.
Note before paragraph 3.01	Deleted.

(continued)

Reference	Change
Footnote 1 in paragraph 3.01	Added.
Former footnote * to heading before paragraph 3.02	Deleted.
Paragraph 3.02	Revised to reflect amendments to the Investment Advisers Act of 1940; footnote † revised; footnotes 3, 4, and 5 added for clarification.
Footnotes 7, 8, 9 in paragraph 3.04	Added for clarification.
Footnote 10 in paragraph 3.04	Revised for passage of time.
Paragraphs 3.29–.30	Added for clarification.
Paragraphs 3.31 and 3.34	Revised for clarification; footnote 13 added to reflect Public Company Accounting Oversight Board (PCAOB) registration rule.
Paragraph 3.38	Revised for clarification; footnote 14 added for clarification; footnote ‖ added.
Paragraphs 3.42–.43 and 3.45–.46	Revised for clarification.
Former paragraph 3.48	Deleted; see paragraphs 3.45–.46.
Paragraph 3.53	Revised for the passage of time.
Paragraph 3.54	Revised for clarification.
Footnote # to heading before paragraph 3.55	Added to reflect amendments to the Investment Advisers Act of 1940.
Paragraph 3.66	Former footnote ‖ deleted; footnote ** added.
Paragraphs 3.68–.69	Revised for clarification.
Footnote †† in paragraph 3.73	Revised.
Paragraph 3.77	Revised for the issuance of Statement on Auditing Standards (SAS) No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325); former footnote ** deleted.
Former paragraphs 3.77–.78	Deleted; see paragraph 3.73.
Footnote ‡‡ in paragraph 3.84	Revised.

Reference	Change
Footnote 21 in paragraph 3.88	Revised for passage of time.
Paragraphs 3.93–.94	Revised for clarification; former footnote ‡‡ deleted; footnote |||| added.
Footnote ## in paragraph 3.95	Added.
Paragraph 3.96	Revised for clarification.
Paragraph 3.131	Footnote *** added; footnote 28 revised for passage of time.
Paragraphs 3.135–.136 and footnotes 30 and 31	Added to reflect amendments to the Investment Advisers Act of 1940; footnote ††† added.
Paragraph 3.137 and footnotes 32 and 33; paragraph 3.138 and footnote 34; paragraphs 3.139–.140 and footnote 35; paragraphs 3.141–.142	Added to reflect amendments to the Investment Advisers Act of 1940; footnote ‡‡‡ added.
Paragraph 3.143	Added to reflect amendments to Investment Advisers Act of 1940; footnote |||||| added.
Footnote ### to heading before paragraph 3.144	Added.
Footnote **** to heading before paragraph 3.145	Added.
Paragraphs 3.145 and 3.149	Revised for clarification; former footnote 21 deleted for passage of time.
Paragraph 4.01; footnote 1 in paragraph 4.02; paragraphs 4.06; 4.08–.09; 4.12–.14; and 4.16	Revised for clarification; former footnotes * and ‡ deleted.
Paragraphs 4.18; 4.20; and 4.22	Revised for clarification; footnote 4 added for clarification.
Paragraphs 4.24–.25; footnote 5 in paragraph 4.25; paragraph 4.34	Revised for clarification.

(continued)

Reference	Change
Former footnote ‖ to heading before paragraph 4.43	Deleted.
Footnote † to heading before paragraph 4.43	Added.
Paragraph 4.47	Revised for clarification.
Former footnote 6 in paragraph 4.48	Deleted for passage of time.
Paragraphs 4.49–.52, 4.55, and 4.67	Revised for clarification.
Former footnote 7 in paragraph 4.71	Deleted for passage of time.
Paragraph 4.73	Revised for clarification; footnote ‡ added.
Former footnotes # and ** to heading before paragraph 4.75	Deleted.
Former footnote 8 to heading before paragraph 4.75	Deleted for passage of time.
Paragraphs 4.75 and 4.83	Revised for clarification.
Former footnotes †† and ‡‡ to heading before paragraph 4.85	Deleted.
Paragraph 4.85	Revised to reflect the issuance of Financial Accounting Standards Board (FASB) Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*; former footnote 11 deleted for passage of time.
Paragraphs 4.86–.88	Added to reflect the issuance of FASB Statement No. 161.
Paragraph 4.89	Revised for clarification.
Paragraphs 4.91–.92	Added to reflect FASB Statement No. 165, *Subsequent Events*, and Accounting Standards Update 2010-09, *Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*.
Paragraph 4.95	Schedules and notes updated for dates, revised for new guidance; outdated material deleted.

Reference	Change
Paragraph 5.01	Revised for clarification; footnote 2 added for clarification.
Paragraph 5.03	Revised for revised PCAOB requirements; footnote † added.
Paragraph 5.04	Revised for clarification; footnote ‡ added.
Footnote 3 to heading before paragraph 5.06	Added to reference amendments to the Investment Advisers Act of 1940.
Paragraphs 5.18 and 5.26	Revised for clarification.
Former footnote 3 in paragraph 5.31	Deleted for passage of time.
Paragraph 5.64	Revised for clarification.
Footnote 7 in paragraph 5.72	Revised for passage of time.
Footnote 9 to heading before paragraph 5.87	Revised for clarification.
Paragraph 5.92	Revised for the issuance of SAS No. 115.
Paragraph 5.99	Revised for clarification.
Former paragraph 5.100	Deleted for passage of time.
Paragraph 5.115	Revised for clarification.
Paragraph 5.122	Revised for the issuance of SAS No. 115; footnote † deleted.
Paragraphs 5.123–.124	Revised for the issuance of SAS No. 115.
Paragraph 5.139	Revised for clarification.
Footnote # in paragraph 5.141	Added.
Former paragraph 5.146	Deleted for passage of time.
Paragraphs 5.172–.173	Revised for clarification.
Paragraph 5.194	Revised for the guidance in AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), and for clarification; footnote ** revised; footnote †† added.
Paragraph 5.195	Revised for the issuance of SAS No. 115.
Footnote * in paragraph 6.01	Added.

(continued)

Reference	*Change*
Paragraphs 6.10 and 6.18	Revised for clarification.
Paragraph 6.22 and footnote 3 in paragraph 6.27	Added for clarification.
Paragraph 6.46	Revised to reflect the issuance of SAS No. 115.
Paragraphs 6.47, 6.49, and 6.55	Revised for clarification; footnote † in paragraph 6.56 added.
Paragraphs 6.59 and 6.65	Revised for clarification; footnote ‡ in paragraph 6.65 added.
Heading before paragraph 6.68 and paragraph 6.68	Added for clarification.
Footnote || to heading before paragraph 6.69	Revised.
Paragraph 7.05	Revised for clarification; former footnote * deleted.
Paragraphs 7.06 and 7.09	Revised for clarification.
Footnote * to heading before paragraph 7.11	Added.
Paragraph 7.11	Revised for clarification.
Former paragraph 7.12	Deleted; see paragraph 7.06.
Former footnote ‡ to heading before paragraph 7.12	Deleted.
Paragraph 7.14	Revised for clarification.
Former paragraph 7.19	Deleted; see paragraph 7.08.
Paragraph 7.20	Revised for clarification; footnote † added.
Paragraph 7.22	Revised for clarification.
Former footnote † to heading before paragraph 7.25	Deleted.
Former paragraph 7.27	Deleted; see paragraph 7.57.
Paragraph 7.30	Revised for clarification; footnote ‡ added.
Paragraphs 7.32–.34	Revised for clarification.

Reference	*Change*
Heading before paragraph 7.35	Added for clarification; footnote || added.
Footnote 2 in paragraph 7.37; paragraphs 7.41–.42 and 7.45	Revised for clarification.
Former paragraph 7.46	Deleted; see paragraph 7.20.
Footnote 5 in paragraph 7.48	Added for clarification.
Former footnote || and footnote # to heading before paragraph 7.66	Deleted.
Paragraph 7.69	Revised for clarification.
Footnotes # and ** in paragraph 7.70	Added.
Former footnote ** in paragraph 7.70	Deleted.
Paragraphs 7.72–.73	Revised for clarification.
Former footnote 9 in paragraph 7.78	Deleted for passage of time; former footnote †† deleted.
Former footnote 10 in paragraph 7.82	Deleted for passage of time; footnote †† added.
Footnote ‡‡ to heading before paragraph 7.83	Added.
Paragraph 7.83	Revised for clarification; former footnote ‡‡ deleted.
Former footnote |||| to heading before paragraph 7.84	Deleted.
Footnote 10 in paragraph 7.85	Revised for clarification.
Paragraph 7.86	Revised for issuance of Securities and Exchange Commission Staff Accounting Bulletin No. 109, *Written Loan Commitments Recorded at Fair Value Through Earnings*.
Paragraphs 7.88–.89	Revised for clarification.

(continued)

Reference	*Change*
Former footnote ## in paragraph 7.93	Deleted.
Footnote 11 in paragraph 7.93 and footnote 12 in paragraph 7.95	Added for clarification.
Paragraph 7.98 and footnote ||||; paragraph 7.113	Revised for clarification.
Appendixes A and B	Revised dates.
Appendixes C and D	Revised dates; deleted example report based on SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*.
Appendix E	Revised dates.
Appendix F	Revised dates; deleted example report based on SAS No. 112.
Appendix G	Revised report for the expiration of the transitional assessment period and for the current form required.
Appendix H	Updated dates.
Appendix M	Updated addresses and telephone numbers.
Former appendix N	Deleted.
Appendix N	Added.

Glossary

The following terms can be found in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary:

box spread. A combination of long calls and short puts (identical with respect to the underlying security issue, number of shares, exercise price, and expiration date) coupled with long puts and short calls (identical with respect to the underlying security issue, number of shares, exercise price, and expiration date). In boxing (coupling), the long calls and short puts with the long puts and short calls, the underlying security issue, the number of shares, and the expiration date remain identical. However, the exercise price of each combination is at a different amount.

fail-to-deliver. Securities that the selling broker-dealer has not delivered to the purchasing broker-dealer at the settlement date.

fail-to-receive. Securities that the purchasing broker-dealer has not received from the selling broker-dealer at the settlement date.

FHLMC. Abbreviation for Federal Home Loan Mortgage Corporation. Often referred to as Freddie Mac, FHLMC is a private corporation authorized by Congress to assist in the development and maintenance of a secondary market in conventional residential mortgages. FHLMC purchases mortgage loans and sells mortgages principally through mortgage participation certificates representing an undivided interest in a group of conventional mortgages. FHLMC guarantees the timely payment of interest and the collection of principal on the participation certificates.

floor broker. A member of a securities exchange who executes transactions on the floor of an exchange for the account of that member's own entity or for the account of other member entities. Broker-dealers often engage floor brokers, who are responsible for executing securities transactions on the exchanges for the account of the broker-dealer. Floor brokers employed by the entity may execute trades on behalf of other broker-dealers, for which the entity is paid a brokerage fee. The purchase and sale department of the broker-dealer maintains the records of floor brokerage fees that are due to other broker-dealers who execute orders on the entity's behalf and brokerage fees due from other broker-dealers.

FNMA. Abbreviation for Federal National Mortgage Association. Often referred to as Fannie Mae, FNMA is an investor-owned corporation established by Congress to support the secondary mortgage loan market by purchasing mortgage loans when other investor funds are limited and selling mortgage loans when other investor funds are available.

GNMA. Abbreviation for Government National Mortgage Association, often referred to as Ginnie Mae. GNMA is a U.S. governmental agency that guarantees certain types of mortgage-backed securities and provides funds for and administers certain types of low-income housing assistance programs.

half-turn. A transaction involving the purchase or sale as either an opening or closing transaction of a commodity futures contract (see **round-turn**).

proprietary transactions. Transactions in financial instruments that broker-dealers execute for their own account.

repurchase agreement (repo agreement). The sale of a security, usually a U.S. government obligation or corporate debt instrument, at a specified price with a simultaneous agreement to repurchase the security, usually at a fixed or determinable price on a specified future date. An agreed-upon interest rate is accrued by the seller-repurchaser over the life of the contract. For financial reporting purposes, the security is treated as part of the broker-dealer's trading and investment inventory, with the amount of the repurchase agreement reflected as a liability.

reverse repurchase agreement (reverse repo or resale agreement). An agreement whereby the purchaser of securities agrees to resell the securities within a specified time at a fixed or determinable price (see **repurchase agreement**).

round-turn. A purchase and a subsequent sale, or a sale and a subsequent purchase, of a commodity futures contract.

The following is a list of additional terms that have been used in this guide:

account executive. See **registered representative**.

active box. A position on the stock record (street side) indicating securities under the control of the broker-dealer that are normally available for the broker-dealer's general use.

adequately collateralized. Indebtedness for which the difference between the amount of the indebtedness and the market value of the collateral is sufficient to make the loan acceptable as a fully secured loan to banks that regularly make comparable loans to broker-dealers in the community.

ADR. Abbreviation for American Depository Receipt, a certificate issued by a U.S. bank that serves as evidence of ownership of original foreign shares. These certificates are transferable and can be traded. The original foreign stock certificates are deposited with a foreign branch or foreign correspondent bank of the issuing U.S. bank.

agency transactions. Transactions in financial instruments that broker-dealers execute on behalf of customers to earn commission income.

aggregate indebtedness. The total of certain liabilities of a broker-dealer that are set forth in SEC Rule 15c3-1. The rule states that a broker-dealer shall not permit its aggregate indebtedness to exceed a specified percentage of its net capital as defined in the rule.

allied member. Any general partner, qualified voting stockholder, or officer of a FINRA (former NYSE) member firm, who is deemed to be a control person of a member organization and who is not himself or herself a member of a stock exchange.

AMEX. Popular name for the American Stock Exchange.

arbitrage. The act of buying a security in one market and simultaneously selling it in another in order to profit from price discrepancies. Also, buying a security subject to exchange, conversion, or reorganization and selling the security or securities to be received upon completion of the exchange, conversion, or reorganization.

ask. The lowest price a seller is willing to accept for a security at a particular time, also known as *offer* by exchanges.

asset-backed commercial paper (ABCP). Short-term promissory notes issued in bearer form by large corporations with similar features to the standard commercial paper, with the exception that the note is secured against specific assets, usually short-term trade receivables from a company (or companies). ABCP may also have liquidity support from a sponsoring bank to allow timely repayment at maturity (see **commercial paper**).

auction rate securities. Long-term debt securities with legal maturities typically of at least 20 years, with interest rates that are reset periodically (typically every week or month, but in some cases every 49, 60, or 90 days) in blind auctions held by investment banks. Most auction rate securities are guaranteed by a third party, typically known as a *bond insurer*, and the bond insurer's rating typically affects the rating of the bond.

back office. The operations area of a brokerage office, containing the bookkeeping, margin, purchase and sales (P&S), cashier's, and dividend departments. The back office function generally supports trading thorough trade reconciliations, confirmations, settlement, and recordkeeping.

bad delivery. A delivery of securities that does not fulfill the requirements for delivery, including the standards required to transfer title to the buyer.

balance order. The net balance instructions, issued by a clearing organization, to receive or deliver securities based on a netting of all trades in a given security settling on the date of netting. The instructions give all the information needed by the member firm to clear its transactions on a given settlement date.

basis point. A measurement of changes in price or yields for fixed-income securities. One basis point equals 0.01 percent, or 10 cents per $1,000 per annum.

best efforts. Refers to an agreement by an underwriter to buy from the issuing corporation only those securities it is able to sell to the public.

bid. The price a buyer is willing to pay for a security at a particular time.

Big Board. Popular name for the New York Stock Exchange.

block trading. The acquisition or disposition of large quantities (10,000 shares or more) or blocks of stock by a broker-dealer in order to facilitate the execution of buy and sell orders of customers, usually institutions. Often, a broker-dealer absorbs a portion of the order for its own account and risk.

blotter. A record of original entry. A book or individual unit used as a record of original entry to record transactions as they occur. It covers purchases, sales, cash receipts and disbursements, and securities received and delivered.

blue list. Daily publication, either or both print and electronic, listing primarily municipal bonds offered for sale.

book entry system. A system in which securities are not represented by physical certificates, but are maintained in computerized records at the custodian (such as the Depository Trust Company) in the name of registered owners.

books closed. The cutoff time that determines the stockholders of record for a prescribed period. Any entries affecting the registration or ownership

of securities for dividend disbursements or proxy purposes must be made before this time.

borrowed. The act of borrowing a security for delivery. The equivalent value in money is usually deposited with the lender.

box. A term used for a "short" position in the stock record representing securities under the control of or in the possession of the broker-dealer. It indicates a place where securities are kept, such as a vault, file cabinet, and so forth. A box is also identified as a safekeeping box, segregation box, name-of box, active box, and so forth.

box count. An actual count of securities either in connection with an audit or with periodic checking.

break. The term applied to that position in the stock record to designate an out-of-balance position between the stock record long and short positions.

broker loans. Money borrowed by broker-dealers from banks. Typically loans are collateralized by DTC eligible stocks with a market value of more than five dollars, subject to concentration limitations.

broker's transfer account. An account kept by the transfer clerk of a broker-dealer giving details of securities transferred for the account of other broker-dealers. The need for the account arises when delivery is made by transfer as directed (TAD) instead of by delivery of the actual certificates.

bulk segregation. Securities (usually constituting excess collateral in margin accounts) that are filed in alphabetical order in special boxes in the vault but that are not specifically identified by owner. The securities are usually in the name of the broker-dealer, who maintains collateral records that indicate the owners.

buy in. The procedure followed by a broker-dealer desiring to settle a buy contract that is past due. The broker-dealer may file a notice termed a buy in with a stock exchange or the National Association of Security Dealers, as appropriate. A copy of the notice is also served on the broker-dealer from whom the securities were to be received. If the securities are not delivered, the stock or bond may be bought in for cash for the account of the broker-dealer from whom the securities are to be received. The difference in price between the buy in and the contract price is adjusted by check from one broker-dealer to another.

buying power. The equity remaining in a margin account after providing for the margining of existing securities in the account in accordance with federal and house margin requirements.

cage. The term given to the area of the broker or dealer's office where the cashier, stock clerks, loan clerks, transfer clerks, blotter clerks, and others have, as a part of their duties, responsibility for receiving and delivering securities.

call (margin). A request, usually in writing, for a margin customer to put up additional collateral (cash or securities).

call loan. A loan that has no definite maturity or rate of interest. The loan may be either called by the lender or paid off by the borrower at any time.

call option. A contract that entitles the holder to buy (call), entirely at his or her option, a specified number of underlying units of a particular security at a specified price at any time until the stated expiration date of the contract. (This is an American-style option; a European-style option is exercisable only at a specific date.) Such an option (which is always for a transferable, round-lot amount) is bought with the expectation that the price will rise above the contract price. If the price rises as anticipated, the purchaser will exercise the option; if it does not, he or she will let the option expire and will lose only the cost of the option. There is both a listed and over-the-counter market in options. (During the existence of an OTC option, the exercise price and number of underlying units are adjusted on the expiration date for cash dividends, rights, and stock dividends or splits.)

carry. The cost of financing (borrowing to buy) a position in financial instruments. Positive carry is a condition that arises if the cost of financing (the short-term rate of interest) is less than the current return of the instrument. Negative carry is a condition that arises if the cost of financing is above the current return of the instrument.

cash account. The account of a customer of a broker-dealer who purchases and sells securities strictly on a cash basis. No credit margin is allowed.

cash sale. A sale with the same trade and settlement dates. The selling broker-dealer must be able to make delivery of the security sold on the trade date. The customer who is selling usually receives a discounted price on the sale for this special service.

cash transaction. A transaction that is expected to clear within the time prescribed by Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System.

cashier's department. A division of the operations department of a broker-dealer that handles the securities and money that are received or delivered by the broker-dealer (see **cage**).

CBOE. Abbreviation for Chicago Board Options Exchange, a national securities exchange based in Chicago that provides a continuous market for trading in put and call options. Various other exchanges (such as the American, NYSE Arca Options, and Philadelphia) also provide such markets.

CFTC. Abbreviation for Commodity Futures Trading Commission, an agency established by Congress to regulate U.S. commodity futures markets and futures commission merchants. Among other things, this agency establishes rules governing the minimum financial, reporting, and audit requirements of its members. Its function is similar to that performed by the SEC in regulating broker-dealers in securities and various securities markets.

churning. The process of excessive purchases and sales in customers' accounts for the purpose of generating commissions.

circuit breaker. A system of trading halts and price limits on equities, options, and futures markets designed to provide a cooling-off period during large, intraday market declines. The breakers are triggered when a market has fallen by a specific amount within a specified period.

cleanup call. An option held by the servicer or its affiliate, which may be the transferor, to purchase the remaining transferred financial assets, or the remaining beneficial interests not held by the transferor, its affiliates,

or its agents, in a qualifying special-purpose entity (SPE) (or in a series of beneficial interests in transferred assets within a qualifying SPE), if the amount of outstanding assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing.

clearance. The act of clearing securities transactions between buyers and sellers; receipt or delivery of securities against payment.

clearing broker. Usually, a broker-dealer who clears the transactions of another broker-dealer (see **correspondent**).

clearinghouse. The central location for matching and settling commodity transactions, collecting and maintaining margin, regulating delivery, and reporting trade information of members. The clearinghouse is responsible to all members for the fulfillment of the contracts and maintains sufficient funds by calling for margin deposits from members.

clearing member. A broker-dealer entitled to use the services of the clearing organization.

clearing number. A number assigned to a member by a clearing organization in order to identify that clearing member.

clearing organization. The central location for matching the security transactions of members (see **clearinghouse**).

commercial paper (CP). Short-term promissory notes issued in bearer form by large corporations, with maturities ranging from overnight to 270 days. However, most paper issued matures in less than 40 days. Standard CP is unsecured and subject to counterparty risk (see **asset-backed commercial paper**).

commodity holdout. Commodity transactions on the broker or dealer's records that are not reported on the clearinghouse sheets.

commodity spreading. Implies open purchase (long) and sale (short) contracts in the same commodity or in different commodities.

comparison. A formal notice that details the terms of the contract between broker-dealers that are parties to nonexchange trades. If the details of the trade are correct, the comparison is stamped (acknowledged) and returned; if they are incorrect, the broker-dealer indicates the differences and returns the comparison (see **DK**).

compliance department. The department of a broker-dealer that enforces adherence to policies established by the broker-dealer, plus all rules and regulations promulgated by the various regulatory agencies.

confirmation. A notice that sets forth the terms of a contract between a broker-dealer and its customer for the purchase or sale of securities. Details shown on a confirmation are the trade date, settlement date, number of shares or par value of bonds, security description, contract price, commission, account number and type of account, and customer's name and address, as well as any other information required.

contract difference. The difference between the contract and the market values of commodities.

contract sheet. A listing of compared and uncompared transactions sent to each member firm by a stock-clearing corporation.

control stock. Securities of an issuer that are owned by an affiliate of that issuer. An affiliate of that issuer is a person who, directly or indirectly through one or more intermediaries, controls or is controlled by or is under common control with the issuer. Control is likely to be found if the person is a director, officer, or owner of a relatively large number of the issuing company's voting securities. However, the notion of control is a factual matter that is determined on a case-by-case basis.

correspondent. One of the parties to an agreement between two broker-dealers who perform services for each other, such as the execution and the clearance of trades or the maintenance of customer accounts.

cover value. The amount necessary to buy-in a short security position at the current market value.

CRD. Abbreviation for Centralized Registration Depository; a computerized filing and data processing system, operated by FINRA, that maintains registration information regarding broker-dealers and their registered personnel.

credit department. See **margin department**.

current market value. As used in connection with margin trading, generally the closing price of a security as of the preceding business day.

CUSIP number. A means of uniformly describing and identifying all stocks and registered bonds in numeric form developed by the Committee on Uniform Security Identification Procedure.

DAP. Abbreviation for delivery against payment; a type of settlement in which the security is paid for when the selling broker-dealer delivers it to the purchaser or their agent. Also referred to as COD (cash on delivery), POD (payment on delivery), and DVP (delivery versus payment).

day loan. A loan made for only one day, generally on an unsecured basis, for the convenience of the broker-dealer.

day traders. Speculators or exchange members on the trading floor who take positions in securities or commodities for a very short period of time and generally liquidate them prior to the close of the same trading day.

definitive certificates. Actual and permanent certificates of bonds or stock given in exchange for temporary receipts. These temporary receipts are usually issued at the time of a new offering, before the engraved certificates are available.

delayed delivery. A transaction involving deferral of the settlement date (which is normally three business days for securities and one business day for options) to some point further in the future as agreed on by both buyer and seller (see **seller's option**).

derivative. A financial instrument, traded on or off an exchange, the price of which is directly dependent upon (that is, derived from) the value of one or more underlying securities, equity indices, debt instruments, commodities, other derivative instruments, or any agreed upon pricing index or arrangement (for example, the movement over time of the Consumer Price Index or freight rates). Derivatives involve the trading of rights or obligations based on the underlying product but do not directly transfer property.

directed sale. Sale by the manager of a syndicate to a customer, usually an institution, of a syndicate member.

discretionary account. An account over which a broker-dealer or some other person has been given authority by the customer to make decisions (including the kind of securities to buy or sell, as well as the date and prices to be paid or received) concerning purchases and sales of securities. The discretion may be complete or limited.

distribution. The sale of a large block of securities to the investing public.

divided liability. Liability in a syndicate or underwriting that is fixed or definite in the amount of shares or principal value for each participant (see **undivided liability**).

dividend department. A division of the operations department that is charged with the collection of dividends and the crediting of these dividends to the accounts of customers.

DK. Abbreviation for "don't know;" an expression used by a broker-dealer to indicate that a transaction another broker-dealer is attempting to confirm or compare is unknown or is questioned (meaning that it is a questioned trade or a QT). When mutual understanding is reached, the transaction is properly compared or canceled.

DTC. Abbreviation for Depository Trust Company, a depository for eligible securities that facilitates clearance between member organizations and banks without the necessity of receiving or delivering actual certificates. DTC is a subsidiary of DTCC.

DTCC. The Depository Trust & Clearing Corporation, a holding company for DTC and NSCC.

due bill. A document, used to adjust security transactions, passed between broker-dealers stating that dividends, rights to subscribe, stock dividends, and so forth, are the property of the holder of the due bill.

DVP. Abbreviation for delivery versus payment; a type of settlement in which the security is paid for when the selling broker-dealer delivers the security to the purchaser or their agent.

ECN. Electronic Communication Network, an alternative trading system that facilitates trading of financial products outside of stock exchanges by directly connecting equity traders, agency brokers, market makers, and investors. ECNs must register with the SEC as a broker-dealer or an exchange and are subject to Regulation ATS.

equity. The net worth in an account carried by a broker-dealer, computed by subtracting the total of the short security values and the debit balance from the total of the long security values and the credit balance. If the result is a net credit, the account is said to liquidate to an equity.

equity securities. Term applied to common and preferred stocks.

equity statements (runs). Statements showing details of an account with security valuations.

exchange tickets. The tickets in a clearing corporation format, prepared by a broker-dealer for each transaction made on an exchange. These tickets list

all pertinent details of the trade and are sent, along with a daily summary listing, to the clearing corporation for comparison and confirmation.

ex-clearinghouse. Transactions that are not settled through the clearinghouse.

ex-dividend. Synonym for without dividend. The buyer of a stock selling ex-dividend does not receive the recently declared dividend. Open buy and sell stop orders and sell stop limit orders in a stock on the ex-dividend date are ordinarily reduced by the value of the particular dividend. In the case of open stop limit orders to sell, both the stop price and the limit price are reduced. Every dividend is payable on a fixed date to all shareholders recorded on the books of the disbursing company as of a previous date of record. For example, a dividend may be declared as payable to holders of record on the books of the disbursing company on a given Friday. Because three business days are allowed for delivering the security via regular-way delivery in transactions on a stock exchange, the exchange would declare the stock ex-dividend as of the opening of the market on the preceding Wednesday. This means that anyone buying the stock on and after Wednesday would not be entitled to the dividend.

execution report. A confirmation notice of the completion of a trade that is sent from the floor of an exchange (for listed securities) or trading desk (for over-the-counter securities) back to the point of origin of the order.

exempt securities. Securities exempted from registration under the Securities Exchange Act of 1934, rather than by action of the Securities and Exchange Commission. Such securities include U.S. government and agency securities, and municipal bonds.

ex-rights. Same principle as ex-dividend. The buyer of stock selling ex-rights is not entitled to the rights distribution.

extension. Permission to extend credit beyond the time prescribed by Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System.

ex-warrants. On occasion, stocks or bonds have warrants attached entitling the holder to subscribe to additional shares within specified periods of time and at specified prices. If these warrants are detached, the security is traded ex-warrants—or without warrants.

fails. Uncompleted securities transactions between two broker-dealers (see **fail-to-deliver** and **fail-to-receive** in the FASB ASC section of the glossary).

financial consultant. See **registered representative**.

FINRA. Financial Industry Regulatory Authority, formed by the combination of the regulatory function of the NASD and the NYSE.

fire wall. (Also referred to as *systems security*.) An intangible barrier between the trading side of a broker-dealer and the corporate finance and research side that prevents broker-dealers from taking advantage of the corporate finance department's inside information.

firm account. An account consisting of securities in which the broker-dealer has taken a position for investment purposes, is making a market (principal wholesaler), or has an interest with another party (joint account).

firm commitment. The agreement of an underwriter to buy the entire issue of a security from the issuing corporation at a specified price.

firm price. The price at which a security can be bought or sold in the over-the-counter market for such period of time as the seller may specify.

flat. A method of trading in certain kinds of bonds. Usually used in trading income bonds that do not pay interest unless it has been earned and declared payable, or in bonds on which the issuer has defaulted in the payment of interest. When bonds are traded "flat," the seller is not entitled to the interest that has accumulated since the date of the last interest payment. The seller of a bond that is traded flat must deliver the bond with all unpaid coupons attached or a due bill authorizing the buyer to collect any payments of interest that may be made by the issuer in the future.

flat statement. A statement with no money or security balance.

floating rate notes (FRN). Notes issued by banks and corporations, typically with maturities of one year or more, that pay a regular coupon with the promise of return of the face value at maturity. The coupon rate is generally pegged to a benchmark rate such as the LIBOR or Euribor. Notes without maturities are known as perpetual FRNs whereby investors can only regain capital by selling the instrument in the secondary market.

floor. Popular name for the area where securities are bought or sold at an exchange.

floor brokerage. The commission charged by one broker-dealer to another for executions of transactions at exchanges.

floor clerk. An employee of a broker-dealer who maintains a liaison between the order room and the floor broker.

floor report. A report of an executed trade given to the floor clerk by the floor broker and containing the number of shares, the price, and the identity of the other broker on the trade.

FOCUS report. Acronym for Financial and Operational Combined Uniform Single report. The uniform regulatory report (Form X-17A-5) filed periodically by all broker-dealers pursuant to Rule 17a-5 of the Securities and Exchange Commission.

forward market. Reference made to nonexchange trading of commodities and securities for settlement at a future date. Contracts of this nature are designed by both the buyer and seller about the delivery time, the amount, and so on.

free securities. Securities that are fully paid for.

free shipment. Shipments of securities, usually to out-of-town broker-dealers, without a draft attached, in order to avoid payment of collection charges.

fully disclosed basis. Situation in which a nonclearing broker introduces a customer to a clearing broker and the customer's name and statement are carried by, and disclosed to, that clearing broker.

fully paid accounts. Customer accounts in which the contract price to purchase securities has been paid. These securities should be locked up in the segregation or safekeeping box.

fungibility. Similar securities that are interchangeable, such as Government National Mortgage Association securities transactions that are interchangeable about interest rate and pool and are traded and settled at an equivalent yield basis.

futures contract. An exchange-traded contract for the purchase or sale of commodities at some time in the future.

give-up. Type of order that is given by a customer to a member firm on whose books the customer does not have an account.

good delivery. Certain basic qualifications that must be met before a security sold may be delivered. The security must be in proper form to comply with the contract of sale and to transfer title by delivery to the purchaser.

good-faith deposit. Deposit to guarantee performance, usually with respect to new issues of securities.

group account. A syndicate or joint account.

GTC. Abbreviation for good till canceled. Also called an open order. If this term appears on an order to buy or sell a security, it means that the order is to remain in effect until it is either executed or canceled.

haircut. Deductions from the net capital of certain specified percentages of the market value of securities and commodity futures contracts that are long and short in the capital and proprietary accounts of a broker-dealer and in the accounts of partners. These deductions are solely for the purpose of computing net capital and are not entered on the books.

holder of record. The party listed as the owner on the transfer records of a corporation.

holder's file. A subsidiary file (punched cards, discs, or tapes) in account sequence showing securities owned or carried in such accounts.

house account. An account used by a broker-dealer to maintain a trading or investment position in a security for itself or its officers or partners. Also, a name given to a customer's account to which no registered representative has been assigned.

house rules. Rules promulgated by the broker-dealer. Usually refers to the maintenance margin required by the broker-dealer over and above the requirements of regulatory bodies.

hypothecation agreement. An agreement signed by a customer that permits his or her broker to use securities in the customer's margin account as collateral for loans made to the broker.

in-house. Within the broker or dealer's firm.

initial margin. The amount of money or its equivalent, specified by the Board of Governors of the Federal Reserve System, that a customer must deposit with his or her broker when the customer buys a security on margin.

interest trades. These transactions, as defined, involve (1) a purchase of Government National Mortgage Association (GNMA) securities for current settlement; (2) a delayed settlement sale of these securities or the possession of a long standby; and (3) a financing of the long GNMA position by a sale under an agreement to repurchase on or before the future delivery date.

international arbitrage. Same as arbitrage, except the markets are in different countries.

investment banker. One who underwrites securities on an initial or secondary basis. This type of underwriting often involves private placements for which the investment banker may act as both a broker and a dealer.

joint account. An account in which two or more persons have an interest.

legal list. A list of securities in which insurance companies, banks, and fiduciaries are permitted by law to invest.

legal transfer. A stock certificate having an assignment executed by an executor, administrator, trustee, guardian, and so forth, and requiring certain legal documents indicating the authority of the party signing the securities.

letter of credit. An unqualified commitment issued by banks or trust companies to pay a specified sum of money immediately upon demand at any time prior to the expiration of the letter of credit. Most commonly used by broker-dealers to satisfy margin requirements at the Options Clearing Corporation or commodity-clearing organizations or in stock-borrowed transactions.

limit order. Also called a limited order or limited price order, an order to buy or sell a security at a price specified by the customer or at a better price, if such a price can be obtained.

liquidity rebate. ECN's credit fee structure that pays a rebate or charges a fee based on whether the trade adds or removes liquidity. Under this credit structure, the ECN makes a profit from the difference between what they rebate and charge for the trade. This differs from the classic exchange-like fee structure that charges an exchange fee to all market participants regardless of whether they add or remove liquidity.

listed security. A security that is traded on an exchange.

loan consent. An agreement signed by a customer that permits the broker-dealer to lend securities owned by the customer to other broker-dealers.

loaned. The act of lending a security, usually for delivery against a short sale. The equivalent value in money is usually deposited by the borrower. This term is the opposite of *borrowed*.

Loanet. An independently owned and operated online real-time accounting service used by brokers and institutions in support of their domestic and international securities borrowing and lending activities. The system provides interfaces to the Depository Trust Company for both receipt and delivery of securities, including market values of the securities, and to clients' internal recordkeeping systems or outside accounting services. In addition, Loanet also provides daily contract comparison for all subscribers engaged in the borrowing and lending of securities and portfolio availability of most major lending institutions.

loan value. The value at which a security is accepted for margin. This value is usually less than, or at a discount from, the current market value.

lock-up. The act of placing securities in safekeeping or segregation.

long. Denotes ownership, or the right to possession, of securities.

long and short record. See **stock record**.

long securities differences. The excess of securities positions accounted for over the broker-dealer's long positions on the stock record. When recorded in a difference account, the excess would be recorded long on the stock record (see **short securities differences**).

maintenance margin. The amount of equity required to be maintained in a margin account in accordance with exchange regulations or house rules.

margin. The equity in an account. The requirements for the amount of margin vary between initial margin and maintenance margin and also according to the type of collateral used in computing the equity.

margin call. A request for additional margin.

margin department. A division of the operations department. Its functions include keeping an up-to-date record of each customer's purchases and sales of securities, carefully monitoring extensions of credit to customers, and the segregation of fully paid for or excess-margin securities.

margin transaction. A transaction in which the broker-dealer advances credit to the customer for a portion of the purchase price.

market maker. A broker-dealer that stands ready to buy or sell a particular security in the over-the-counter market at prices the broker-dealer has quoted. Also, an options trader on the floor of a registered exchange who stands ready to buy or sell a particular option.

market price. Usually means the last reported price at which a security has been sold.

mark to market. Term used to describe the process of valuing (market value or fair value) security positions for purposes of determining profit or loss on security positions in proprietary trading and investment accounts. The term also is applied to open contracts between broker-dealers and clearing corporations for determining the adjustments to be made for funds owed or receivable as a result of adjusting those contracts to current values.

mark up. The difference between what a broker-dealer has paid for a security and the price at which it offers the security to another person.

master file. A file that contains the official account numbers and descriptions of securities and customers' names and addresses.

material associated person (MAP). The determination of whether an affiliated person of a broker or dealer is a material associated person involves consideration of all aspects of the activities of, and the relationship between, both entities, including the factors enumerated in SEC Rule 17h-1T.

matrix pricing. A mathematical technique used to value normal institutional-size trading units of debt securities without relying exclusively on quoted prices of the specific security. Factors such as the issue's coupon or stated interest rate, maturity, and rating and quoted prices of similar issues are considered in developing the issue's current market yield.

maximum loan value. The percentage of the purchase price of a security that a broker-dealer may lend to a customer who is buying a security on margin.

member corporation. A broker-dealer that is organized as a corporation and that has at least one director-holder of voting stock who is a member of an organized stock exchange.

member firm. A broker-dealer that is organized as a partnership and that has at least one general partner who is a member of an organized stock exchange.

mixed account. An account containing both long and short securities.

money market deposit account. Not to be confused with a money market mutual fund, this account is a type of savings account offered by banks and credit unions under Regulation D. A money market deposit account generally requires a higher minimum balance and a limited number of transactions and pays a higher interest rate. Assets in this account are FDIC insured. The interest rate is either negotiated or determined by the bank and is based on a benchmark rate. These accounts are not subject to regulatory haircuts.

money market mutual fund. A type of mutual fund subject to the SEC Rule 2a-7, with an objective to preserve capital and maintain liquidity. Assets in this account are not FDIC insured. Although possible, investments in money market mutual funds have a low likelihood of loss of capital. The haircut on this type of investment is 2 percent (see SEC Rule 15c3-1).

Municipal Securities Rulemaking Board (MSRB). Agency established by Congress to establish rules for broker-dealers effecting transactions in obligations of, or guaranteed by, state or local governments or any agency or instrumentality thereof.

name-of securities. Securities registered in the name of customers of the broker-dealer (see **safekeeping**).

NASD. Abbreviation for National Association of Securities Dealers, Inc., formerly an association of broker-dealers doing business in the over-the-counter market. Prior to its incorporation into FINRA, the association supervised and regulated the trading conduct and sales practices of its members. See **FINRA**.

NASDAQ. Abbreviation for the NASDAQ Stock Market, an electronic stock market (formerly known as the National Association of Securities Dealers Automated Quotation System).

net capital. Net worth of a broker-dealer, less certain items such as exchange memberships, the carrying value of securities that are not readily marketable, haircuts on marketable securities in proprietary accounts, furniture and equipment, and other illiquid assets, as defined in the net capital rules.

new issue. A security that is sold by an issuing corporation for the first time. It may be referred to as an initial public offering or IPO.

no-action letter. A letter issued to a broker-dealer by the staff of the Securities and Exchange Commission (SEC) in response to a request filed by the broker-dealer describing a proposed business activity that may or may not conform to SEC rules and regulations. In a no-action letter, the SEC staff indicates that, based on the facts presented by the broker-dealer, the SEC staff will recommend no action be taken against the broker-dealer for

engaging in the proposed activity. A no-action letter does not have the force of law; however, it represents an interpretation of the SEC staff that may be applied in a situation where the broker-dealer is engaging in an activity not addressed by existing SEC rules and regulations.

NSCC. Abbreviation for National Securities Clearing Corporation, a subsidiary of DTCC, that provides trade processing, clearance, delivery, and settlement services to its members. It deals with brokers, dealers, and banks in the United States and Canada.

NYSE. Abbreviation for New York Stock Exchange, a not-for-profit corporation that is the largest securities exchange in the United States, and now a part of NYSE Euronext. It furnishes facilities for its members, allied members, member firms, and member corporations to aid them in conducting securities business.

odd lot. A quantity of securities that is less than the trading unit or round lot, usually a quantity less than an even 100 shares.

off-board. Used to describe transactions in listed securities that are not executed on a stock exchange.

offer. The lowest price at which a seller is willing to sell a security.

omnibus account. An open account carried and cleared by another broker-dealer and containing accounts of undisclosed customers on a commingled basis that are carried individually on the books of the broker-dealer introducing the trades.

operations department. The name associated with the overall clerical functions of a broker-dealer. Sometimes referred to as the back office.

option conversion accounts. Accounts consisting of long option and short option positions and a related underlying securities position.

optional commitment. A call exercisable at a future date. A long optional commitment is an option to purchase Government National Mortgage Association securities; a short optional commitment is an option to sell.

optional commitment fee. The amount received or paid for the sale or purchase of an optional commitment.

optional dividend. A dividend that is payable in either stock or cash at the option of the holder of record.

order department. A division of the operations department that receives customers' orders and transmits them either to the floor of a stock exchange or to the trading department for execution. The order department also receives notices of executed trades and transmits such notices to the purchases and sales department and to the registered representatives.

order room. Another name for the order department.

OTC. Abbreviation for over-the-counter. A securities trading market made up of broker-dealers that may or may not be members of a securities exchange. Thousands of companies either have insufficient shares outstanding, stockholders, or earnings to warrant application for or maintaining a listing on a stock exchange, or choose not to be listed on a stock exchange for other business or economic reasons. Securities of these and other companies are traded in the OTC market between broker-dealers that act as either

principals (dealers) or agents (brokers) for customers. The OTC market is the principal market for U.S. government and corporate bonds and municipal securities. In the United States, over-the-counter trading in securities is carried out by market makers using interdealer quotation services such as Pink Quote (operated by Pink OTC Markets) and OTC Bulletin Board (operated by FINRA).

overdelivery. Delivering a greater amount of securities than called for, the surplus amount being returned by transferring it to the name of the delivering broker-dealer. An overdelivery can also occur if excess securities are delivered in error.

over the window. The direct delivery of securities between two brokerage concerns, rather than by use of the clearinghouse facilities. Delivery is made by hand to the receive window of the broker and is said to be "over the window."

pair off. This can occur if two broker-dealers owe each other the same number of shares of the same security. Instead of actually receiving the security and delivering it back again, they will "pair off" the transaction by giving or receiving a check for the difference in price or exchanging checks for the full amount of each side of the transaction.

papers. A term sometimes given to put and call options.

payable date. The date on which a dividend is payable to holders of record as of some previous date.

pink sheets. Pink sheets got their name because they were formerly a listing of over-the-counter securities published on pink paper by the National Quotation Bureau (now Pink OTC Markets Inc.). Yellow sheets are to bonds what pink sheets are to corporate equity securities traded in the OTC market (see **OTC**).

point. If used in connection with the purchase or sale of stocks, point means a rise or decline of $1 per share. If used in connection with the purchase or sale of bonds, it means a rise or decline of $10 per $1,000 principal amount.

point balance. A daily summary by commodity for exchange-traded futures and options on futures contracts that contains all open long and short positions and the original transaction price valued at the closing settlement prices. Separate summaries are prepared for customer transactions and proprietary and noncustomer transactions.

position. This term is used in referring to the securities "long" or "short" in an account or in the stock record.

post. A designated place on an exchange floor where specific securities must be traded.

private placement. The direct sale of a block of securities, either a new issue or a secondary issue, to a single investor or a group of investors. This is usually accomplished through an investment banker.

proxy department. A division of the operations department that helps corporations communicate with their stockholders in cases in which stock certificates are in street name.

purchase and sales department. A division of the operations department that is concerned with the preparation of customers' confirmations of security transactions and the comparison of such transactions with other brokerage concerns.

put option. A contract that entitles the holder to sell (put), entirely at his or her option, a specified number of underlying units of a particular security at a specified price anytime until the stated expiration date of the contract. (This is an American-style option; a European-style option is exercisable only at a specific date.) Such an option, which is always for a round-lot amount and which is transferable, is bought with the expectation of a price decline below the contract price. If the price decline occurs, the purchaser will exercise or sell the option. If the decline does not occur, he or she will let the option expire and will lose only the cost of the option. There are both listed and over-the-counter (OTC) markets in options. During the existence of an OTC option, the exercise price and number of underlying units are adjusted on the ex-date for cash dividends, rights, and stock dividends or splits.

puts and calls. Options to sell (put) or buy (call) securities within a specified period of time at specified prices (see **put option; call option; straddle**).

quote. The price of a security. It may be the price of the last sale made on an exchange or the current bid and ask price.

receive-and-deliver department. A division of the operations department responsible for the physical receipt and delivery of incoming and outgoing securities. Often, it is also responsible for the daily balancing of cash entries made by the various operations department divisions.

record date. The date on which the stockholder's name must be registered on the books of a company in order to receive a declared dividend or among other things to vote on company affairs.

registered owner. The owner of a security, whose name is recorded on the face of the certificate and on the books of the issuing corporation or its agent.

registered representative. Salesperson (often referred to as an account executive) of the broker-dealer. Salespeople are registered with the CRD (see **CRD**).

registered trader. Individuals or entities who have obtained approval to trade for their own account on the floor of a national securities exchange. Such individuals or entities have certain obligations with regard to the stabilization of the market in securities for which they are registered. They also have less stringent financial responsibilities and reporting requirements than do full-service broker-dealers.

registrar. Usually a trust company or bank charged with the responsibility of preventing the issuance of more stock than that authorized by the issuing company.

regular way delivery. Unless otherwise specified, the delivery of securities (other than those of the U.S. government) to the buying broker-dealer by the selling broker-dealer, with payments received on the third business day after the transaction. The regular-way delivery day for government bonds is the business day following the transaction.

Regulation G. The Federal Reserve Board regulation governing the amount of credit that persons other than banks or broker-dealers may extend to investors who borrow money to buy securities on margin.

Regulation T. The Federal Reserve Board regulation governing the amount of credit that broker-dealers may extend to customers who buy securities.

Regulation U. The Federal Reserve Board regulation governing the amount of credit that banks may extend to customers, including broker-dealers, who borrow money to buy securities on margin.

Regulation X. The Federal Reserve Board regulation specifying conditions with which a U.S. borrower, and foreign persons controlled by or acting on behalf of or in conjunction with a U.S. borrower, must comply when obtaining credit outside the United States for the purpose of purchasing or carrying U.S. securities or when obtaining credit within the United States to purchase or carry any securities.

reorganization department. A division of the operations department that processes securities involving corporate reorganizations, mergers, consolidations, subscriptions, and the exchange of convertible securities into common stocks.

restricted account. This means that a broker may not buy securities for a particular customer for a specified period of time unless the customer has deposited enough money in his or her account to pay for the securities before the customer's orders are executed.

reverse split. Opposite of stock split.

rights. The privilege offered by a corporation to its stockholders to subscribe to certain securities, usually at a advantageous price.

round lot. A unit of trading or a multiple thereof. On the New York Stock Exchange, the unit of trading is generally 100 shares in stocks and $1,000 par value in bonds.

RVP. Abbreviation for receive versus payment.

safekeeping. A position on the stock record (street side) indicating securities that have been fully paid for by customers and that are being held by the broker-dealer under custody arrangements. These securities are generally registered in the name of the customer.

safekeeping box. Location in which customers' fully paid-for securities are kept.

SCA. Abbreviation for subsequent coupons attached.

scrip. A certificate issued to stockholders of a corporation that may be exchanged for fractional shares of stock or the equivalent in cash by a fixed date. Scrip is usually issued in connection with a stock dividend or a stock split.

seat. Popular name for a membership on a stock exchange.

SEC. Abbreviation for Securities and Exchange Commission. An agency established by the U.S. Congress to administer federal securities laws.

secondary distribution. The sale of a large block of listed securities (other than an initial issue of a corporation) outside of the exchange on which

they are listed. It is usually the holdings of a large individual stockholder or an estate that are being liquidated.

securities borrowed. See **borrowed**.

securities loaned. See **loaned.**

securities not readily marketable. This term refers to (1) securities, except exempted securities, for which there is no market on a securities exchange or no independent publicly quoted market; (2) securities that cannot be publicly offered or sold unless registration has been effected under the Securities Act of 1933 (or the conditions of an exemption, such as Regulation A under Section 3(b) of this act, have been complied with); or (3) securities that cannot be offered or sold because of other arrangements, restrictions, or conditions applicable to the securities or the broker-dealer.

segregation. A position on the stock record (street side) indicating customers' fully paid-for or excess-margin securities that are subject to the customers' instructions and that have been set aside. These securities are generally in the name of the broker-dealer (see **bulk segregation**).

segregation box. Location in which segregated securities are kept.

sell out. Action taken by a broker-dealer to liquidate an account or transaction for failure to maintain proper margin or make timely payment.

seller's option. Transaction that, by agreement, is to be settled at a date later than the usual regular-way transaction.

selling against the box. This is similar to a short sale except that the seller already owns the stock being sold but keeps possession of it and so has to borrow the equivalent stock with which to make delivery to the purchaser.

selling concession. A discount in the public offering price offered by the issuer to members of its underwriting group.

selling group. A group of broker-dealers that has formed a joint account for the sale of securities, usually in connection with an underwriting.

service bureau. A data processing center that processes the transactions of broker-dealers. These centers are located away from the broker-dealer's office.

settlement date. The date on which a securities transaction is to be settled by the delivery or receipt of securities and the receipt or payment of cash.

settlement price. The price at which a security or commodity is to be settled. Used primarily in connection with clearing organization operations.

short. A stock record position (street side) that represents location (such as box, transfer, and so forth) or due from (such as failed to receive or owed to the brokerage concern by a customer.)

short against the box. See **selling against the box**.

short covering. The purchase of securities so that stock previously borrowed to make delivery on a short sale may be returned.

short sale. A sale of securities that requires borrowing equivalent securities to make delivery to the purchaser.

short securities differences. The excess of securities positions for which the broker-dealer is accountable on its stock record (longs) over those whose locations have been accounted for (shorts) after a securities verification. When recorded in a difference account, the excess would be recorded short on the stock record. See **long securities differences**.

SIAC. Abbreviation for Securities Industry Automation Corporation. An organization that provides automation, data processing, and clearing and communication services to the securities industry, including the National Securities Clearing Corporation.

signature guarantee. In order that a registered security may be a good delivery on the exchange or a good transfer, the signature of the registered owner must be properly guaranteed. The guarantee of a stock exchange member or a bank is usually considered sufficient guarantee.

single stock future. A contract for the sale or future delivery of a single security.

SIPC. Abbreviation for Securities Investor Protection Corporation, a corporation established for the purpose of protecting customers of broker-dealers in financial difficulty.

specialist. A broker who is a member of an exchange and who operates on the floor of the exchange to execute transactions and to maintain an orderly market in certain specified securities.

special offering. The sale of a large block of securities on the floor of a stock exchange. The sale is made in accordance with special procedures worked out by officials of the exchange.

split. The action of increasing the number of outstanding shares of stock of a company in order to decrease the market price and afford a greater distribution of the shares. For example, two shares for each share held will have the effect of reducing the price of the shares by approximately one-half.

spot (commodity). (1) The actual commodity as distinguished from a futures contract. (2) An outgrowth of the phrase "on the spot," it usually refers to a cash market price for stocks of the physical commodity that are available for immediate delivery. (3) This term is also used when referring to the futures contract of the current month, in which case trading is still "futures" trading but delivery is possible at any time.

spread. A combination of a put and call option at different prices—one below and the other above the current market price. Also refers to the difference between the bid and asked prices of a security.

SRO. Abbreviation for self-regulatory organization. An SRO, of which a broker-dealer is a member, assumes responsibility for monitoring the broker-dealer's compliance with minimum financial and related reporting requirements.

standby. A put exercisable at a future date. A long standby is an option to sell Government National Mortgage Association securities; a short standby is a commitment to buy.

standby fee. A negotiated amount received or paid for the sale or purchase of a standby.

stock dividend. A dividend payable in the stock of the issuing corporation.

stock power. A legal document used in lieu of the assignment section of a stock certificate.

stock record (or position record). The record of individual securities on which both the long and short positions are shown. For each security, the total of the long positions and the total of the short positions should be in balance.

stock record department. A division of the operations department that keeps up-to-date records of all securities positions, and is usually responsible for reconciling out-of-balance conditions.

stock split. See **split**.

stockholder of record. A stockholder whose name is registered on the books of the issuing corporation.

stop order. Also called a stop loss order, this is an order used by a customer to protect a paper profit in a security or to keep down a possible loss in a security. The stop order becomes a market order if the price of the security reaches or sells through the price specified by the customer.

straddle. A combination of one put and one call, identical with respect to the security issue, number of shares, exercise price, and expiration date.

street. A shortened term for Wall Street that refers to brokers, dealers, and other financial business concerns.

street item. A transaction or account between broker-dealers (for example, fail-to-receive, fail-to-deliver, stock loaned, and stock borrowed).

street name. Securities held in the name of a broker-dealer or a nominee instead of in customers' names are said to be carried in street name.

striking price. The price at which Government National Mortgage Association securities can be purchased or sold upon the exercise of a standby or optional commitment. The price at which an option (put or call) can be exercised (sometimes called the exercise price).

subscription. The offer to purchase a certain offering, such as a certain number of shares of the stipulated stock or principal amount of bonds, for a stipulated amount of money. The offer is not binding unless accepted by the proper authorized representatives of the issuing corporation.

substitution. The act of withdrawing securities from a bank loan and substituting other securities of approximately equal value.

suspense account. An account used to record securities or monies that cannot be immediately identified and cleared (for example, reclamations, DK items, and bad deliveries).

syndicate. A group of broker-dealers that underwrites and distributes new issues of securities or large blocks of an outstanding issue.

TAD. An acronym for transfer as directed.

takeoff. Sometimes referred to as a daily activity list, this is a daily record showing the net changes in each security. A separate record is prepared for each security, and the information is used to post (update) the stock record.

Also, a record of the long and short positions in a security on the record date, used by the dividend department to make the appropriate dividend entries.

tax stamp. A rubber-stamp facsimile (in some instances, a documentary stamp) affixed to a certificate to indicate that all applicable transfer taxes for the item have been paid.

TBA. Abbreviation for to be announced future government sponsored enterprises' pools that are bought and sold for future settlement. TBA refers to the announcement of the specific pools to be delivered or received.

ticker. An instrument that prints the price at which a security has been traded on an exchange after the trade has been executed.

time loan. A loan having a definite date of maturity and a specified rate of interest for the entire period.

trade. A term that indicates the consummation of a securities transaction, either a purchase or a sale.

trade date. The date on which a securities transaction is actually executed.

trader. An employee of a broker-dealer who executes orders in the over-the-counter market for customers. Also, a person who buys or sells securities for his or her own or his or her company's account for short-term profit.

trading post. Another name for post.

trading unit. The unit by which the security is traded on an exchange, usually 100 shares of stock or $1,000 principal amount of bonds (see **round lot**).

transfer. Usually refers to the act of changing the ownership of registered securities on the books of the issuing corporation.

transfer agent. A transfer agent keeps a record of the name and address of each registered shareholder and the number of shares each owns. The agent sees that certificates presented to his or her office for transfer are properly canceled and that new certificates are issued in the name of the transferee.

transfer department. A division of the operations department that matches, processes, and controls securities being transferred.

two-dollar broker. A name given to a member of an exchange who executes orders for other brokers on that exchange.

underwriting. The act of distributing a new issue of securities or a large block of issued securities, that is, a secondary offering.

undivided liability. An arrangement whereby each member of an underwriting syndicate is liable for his or her proportionate share of unsold securities in the underwriting account regardless of the number of securities the member has previously sold.

undue concentration. The additional haircut from net capital (see SEC Rule 15c3-1) on the market value of certain proprietary security positions of a single class or series of the same issuer that exceeds 10 percent of a broker or dealer's net capital before haircuts.

unlisted security. A security that is not listed on an exchange.

up-front fee. The amount of cash paid to a delayed-settlement to-be-announced securities or Government National Mortgage Association purchaser that is offset by an increase in the sales price.

value date. See **settlement date**.

valued stock record. The stock record at the examination date, with each security position other than those in segregation and safekeeping assigned a price. Remaining quantities within the position are valued at the assigned price.

variable rate demand obligations. Short-term obligations that are characterized by a "put" or demand feature that gives the bondholder the ability to "put" the bonds back to the issuer. If the "put" bonds cannot be remarketed to another investor, a liquidity facility issued by a financial institution, such as a standby bond purchase agreement, letter of credit, or line of credit, typically provides the issuer's funding to cover the put.

variation margin. A term, used in commodity operations, that refers to the last-day point fluctuation (the difference between the prior day's settling price and the last day's settling price) on net positions long and short.

warrants. Rights to purchase additional securities. Usually affixed to the certificate at the time securities are originally issued. Also, a document evidencing rights, for instance, a warrant for 125 rights.

when-distributed. Refers to the distribution of new securities. Transactions are sometimes entered into on a when-distributed basis before the distribution takes place.

when-issued. A short form of *when, as, and if issued*. The term indicates a conditional transaction in a security authorized for issuance but not yet actually issued. All when-issued transactions are on an "if" basis, to be settled if and when the actual security is issued.

window. A term applied to a place in the office of a broker-dealer where securities are actually received or delivered.

window ticket. A term applied to a document given to the broker-dealer by a transfer agent as a receipt. Also applies to a transfer document originating with the brokerage concern (broker-originated window ticket).

wire house. A brokerage concern that has a network of communications (telephone or teletype) that links the main office to branch offices and to offices of correspondent brokerage concerns.

wire room. See **order department; order room**.

yield. The return on investment that an investor will receive from dividends or interest. The return is expressed as a percentage of the current market price of the security or, if the investor already owns the security, of the price he or she paid. The return on stocks is computed by dividing the total dividends paid in the past calendar year by the price of the stock. The return on bonds is computed by dividing the interest by the price of the bid and is computed as yield to maturity or as yield to earliest call.

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