

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

12 September 2011

Re: PCAOB Rulemaking Docket Matter No. 035 – Proposed Standards for attestation engagements related to broker and dealer compliance or exemption reports required by the U.S. Securities and Exchange Commission and related amendments to PCAOB standards

Dear Office of the Secretary:

Ernst & Young LLP is pleased to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) proposed standards for attestation engagements of broker and dealer compliance or exemption reports (Proposed Examination Standard, Proposed Review Standard and, collectively, Proposed Standards) and related commentary (Proposing Release).

We generally support the Proposed Examination Standard and believe it and the proposed amendments respond to the Securities and Exchange Commission's (SEC) proposed amendments to the broker-dealer financial reporting rule under the Securities Exchange Act of 1934 (SEC Proposed Rule 17a-5). We also believe the Proposed Examination Standard provides a good framework for auditors to examine the specific assertions in a broker-dealer's compliance report (Compliance Report) as required by SEC Proposed Rule 17a-5. We do not support requiring a review engagement for a broker-dealer's assertion that it is exempt from Rule 15c3-3 (Exemption Report), as contemplated by the Proposed Review Standard.

We encourage the PCAOB to review our comment letter on SEC Proposed Rule 17a-5, which also discusses many of the matters addressed below.

- ▶ We support the PCAOB's proposed effective date. In our comment letter to the SEC, we recommend that the SEC align the effective date of SEC Proposed Rule 17a-5 with the Proposed Standards to give broker-dealers and their auditors the time to adequately address final SEC rules.
- ▶ We recommend that the PCAOB provide additional guidance on how auditors should evaluate potential instances of material non-compliance, given the heightened reporting and notification requirements for material non-compliance matters contemplated in SEC Proposed Rule 17a-5.
- ▶ We recommend that, rather than require a review engagement of a broker-dealer's assertion that it is exempt from Rule 15c3-3, the PCAOB should require the performance of an agreed-upon procedures engagement or an examination engagement. In either case, the Board would have to develop suitable procedures or suitable criteria.

- ▶ We recommend that the PCAOB provide guidance on specific engagement quality reviewer (EQR) procedures to be performed in the contemplated compliance and exemption examination and review engagements. AS 7 does not presently provide specific guidance for these types of engagements and, as drafted, the Proposed Standards do not outline any amendments to AS 7 in this important area.
- ▶ We believe that the PCAOB would help auditors apply the Proposed Standards more consistently if it clarifies aspects of the Proposed Standards, as outlined below.

We have organized our detailed comments according to the structure of the Proposing Release.

Effective date

In our comment letter to the SEC, we recommend that the SEC eliminate any transition period for carrying broker-dealers and defer the effective date of SEC Proposed Rule 17a-5 to fiscal years ending on or after 15 December 2012 to align with the effective date of the Proposed Standards. We believe this will give broker-dealers and their auditors time to effectively address the final rules including reviewing and evaluating the full body of PCAOB auditing standards (excluding those specifically required for integrated audits) to identify and evaluate all relevant changes to their audit methods for broker-dealers. We believe the Board must work closely with the SEC to make the Proposed Standards and the SEC Proposed Rule 17a-5 effective at the same time.

If the proposed SEC effective dates are adopted, over the course of approximately twelve months the standards by which auditors conduct audits of broker-dealers will change from US GAAS to current PCAOB standards, and finally, to the Proposed Standards. We believe that having a single transition from current US GAAS to the final PCAOB standards in this area will be more efficient for auditors and for the Board's interim broker-dealer audit inspection program.

Independence

The Proposing Release indicates that auditors of non-issuer broker-dealers are not subject to PCAOB Rules 3521 through 3526. We recommend that this point be made explicit in the final standards. For example, what is now paragraph 6c of the Proposed Examination Standard and what is now paragraph 5c of the Proposed Review Standard should include a reference indicating that auditors of non-issuer broker-dealers are not subject to PCAOB Rules 3521 through 3526.

Proposed Attestation Standard, Examination Engagements Regarding Compliance Reports of Brokers and Dealers

Objective

SEC Proposed Rule 17a-5 would require carrying broker-dealers to file a new report asserting compliance with the Financial Responsibility Rules and related internal control and an examination report from their independent registered public accountants that addresses the assertions in the Compliance Report. The Financial Responsibility Rules are identified in SEC Proposed Rule 17a-5 as (1) Rule 15c3-1, (2) Rule 15c3-3, (3) Rule 17a-13 and (4) the Account Statement Rule.

One of the three assertions to be made by a broker-dealer is “whether the broker-dealer was in compliance in all material respects with the Financial Responsibility Rules as of its fiscal year-end.”¹ We note that a broker-dealer may need to interpret requirements of the Financial Responsibility Rules when the rules do not specifically address an aspect of its operations. In other cases, a broker-dealer may rely on informal discussions with the SEC and (or) its designated examining authority (DEA). To better support the assertions made in these circumstances, we recommend in our letter to the SEC that the Commission require broker-dealers to formally document interpretations and obtain evidence of agreements reached with the SEC and (or) its DEA when they have relied on interpretations not cited in the Financial Responsibility Rules. We believe specific PCAOB guidance is needed that outlines the procedures the auditor should perform to determine compliance with this assertion when a broker-dealer has interpreted requirements of the Financial Responsibility Rules or has relied on discussions with the SEC and (or) its DEA.

Another assertion to be made by a broker-dealer is “whether the information used to assert compliance with the Financial Responsibility Rules was derived from the books and records of the broker-dealer.”² In our comment letter to the SEC, we request clarification of the definition of “books and records.” We believe specific PCAOB guidance is needed that outlines the procedures the auditor should perform to determine compliance with this assertion.

General requirements

The Proposed Examination Standard requires the auditor that performs an examination engagement to obtain an understanding of the Financial Responsibility Rules and other rules and regulations relevant to the broker’s or dealer’s assertions.³ Auditors would benefit if the Board were to specify the level of understanding of the Financial Responsibility Rules that auditors are expected to have as well as how such understanding should be documented. Furthermore, open-ended requirements such as “other rules and regulations that are relevant to the broker’s or dealer’s assertions” are too broad to allow auditors to identify suitable criteria and express an opinion on management’s assertion. We recommend that the Board omit the reference to “other rules and regulations that are relevant to the broker’s or dealer’s assertions.”

Clarification of the assessment of material non-compliance

SEC Proposed Rule 17a-5 defines an instance of material non-compliance as a “failure by the broker-dealer to comply with any of the requirements of the Financial Responsibility Rules in all material respects.”⁴

¹ See proposed paragraph (d)(3)(i)(B)(1) of SEC Proposed Rule 17a-5.

² See proposed paragraph (d)(3)(i)(B)(2) of SEC Proposed Rule 17a-5.

³ See proposed paragraph 6b of the Proposed Examination Standard.

⁴ See proposed paragraph (d)(3)(ii) of SEC Proposed Rule 17a-5.

The Proposed Examination Standard notes that to “express an opinion on the assertion made by a broker-dealer in a compliance report, the auditor must plan and perform the examination engagement to obtain reasonable assurance about whether (1) one or more instances of material non-compliance exist as of the date specified in the broker’s or dealer’s assertion and (2) one or more instances of material weakness exist during the period specified in the broker’s or dealer’s assertion.”⁵

The Proposed Examination Standard also states that the auditor “should take into account the following matters in his or her consideration of the materiality of non-compliance: (a) the nature of the specified Financial Responsibility Rules, which may or may not be quantifiable in monetary terms; (b) the nature and frequency of non-compliance; and (c) qualitative considerations.”⁶

We believe the Proposed Examination Standard does not provide sufficient guidance for auditors to assess the factors relevant to determining whether an instance of non-compliance for each of the identified Financial Responsibility Rules is material. Without additional guidance in this important area, we believe it is likely that different auditors may reach different conclusions on whether the same or similar instances of non-compliance are material, which we do not believe furthers the objectives of SEC Proposed Rule 17a-5.

To highlight the areas where additional implementation guidance would be helpful, we ask the following questions in our comment letter to the SEC:

- ▶ Would a different materiality assessment be made for each of the Financial Responsibility Rules, given that the first two (Rules 15c3-1 and 15c3-3) may generally be more quantifiable than the second two (Rule 17a-13 and the Account Statement Rule)?
- ▶ For Rules 15c3-1 and 15c3-3, would an error that was quantitatively significant in the calculation of net capital or the customer reserve formula but did not result in a failure to maintain either the minimum amount of net capital or the adequate amount of segregated cash or qualified securities constitute an instance of material non-compliance?
- ▶ What level of consideration should be given to qualitative factors in evaluating an instance of material non-compliance with Rule 17a-13 and the Account Statement Rule? For example, would the determination of whether the failure to send a single customer statement is a material non-compliance event be based on the total population of customer statements required to be sent (one of five versus one of five thousand)? Furthermore, if one or more customer statements contained errors or omissions of required information, would these errors or omissions be evaluated as instances of material non-compliance based on the materiality of the items to the individual customer statement or to the dollar value of all customer statements?
- ▶ How specifically should an error or misstatement discovered during the audit of a broker-dealer’s financial statements be evaluated to assess whether an instance of material non-compliance has occurred?

⁵ See proposed paragraph 4 of the Proposed Examination Standard.

⁶ See proposed paragraph 10 of the Proposed Examination Standard.

We believe that auditors need clear, well-defined standards to identify instances of material non-compliance. The PCAOB should include examples of instances of material non-compliance with each of the Financial Responsibility Rules in the final standards.

Testing controls over compliance

One factor that the Proposed Examination Standard says affects the risk associated with a control is “the extent of use of part-time personnel to perform controls over compliance.”⁷ We do not believe that the use of part-time personnel in and of itself is a factor that affects the risk associated with a control. In making this assessment, we believe it is more appropriate to evaluate the competence and objectivity of personnel executing the controls, their knowledge of the Financial Responsibility Rules and their authority in the broker-dealer organization. We therefore recommend that that Board omit this risk factor.

We believe clarification is needed relative to the use of audit evidence obtained in past examination engagements. The Proposed Examination Standard indicates that auditors “should obtain evidence during the current year about the design and operating effectiveness of controls selected for testing.”⁸ That same paragraph also discusses using evidence obtained in a prior year. The PCAOB should clarify in this paragraph how evidence obtained in the prior year may affect the nature, timing and extent of the testing performed during the current year examination.

Auditor’s examination report

We recommend revising paragraphs 39 and 40 of the Proposed Examination Standard. A broker-dealer’s assertions are based on regulatory requirements (e.g., net capital computations pursuant to Rule 15c3-1 and reserve requirements pursuant to Rule 15c3-3) that may be subject to legal interpretation. As a result, we suggest adding a sentence to the scope paragraph of the examination and review reports indicating that the auditor’s examination does not provide a legal determination of the broker-dealer’s compliance with specific requirements, similar to established guidance in the PCAOB’s interim attestation standards.⁹

We also believe the Proposed Examination Standard should permit the inclusion of a paragraph in the examination report describing a broker-dealer’s interpretation of the requirements of the Financial Responsibility Rules and the basis for any interpretations, including discussions with the SEC and (or) its DEA, in reaching its compliance assertion. This would be similar to guidance in the PCAOB’s interim attestation standards.¹⁰

We also request that the PCAOB allow auditors to restrict the use of the examination reports. Auditors have previously restricted the use of internal control reports to the board of directors, management, the SEC and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act

⁷ See paragraph 17 of the Proposed Examination Standard.

⁸ See paragraph 23 of the Proposed Examination Standard.

⁹ See PCAOB interim attestation standard AT §601.56.

¹⁰ See PCAOB interim attestation standard AT §601.59.

of 1934. The Proposed Standards do not allow auditors to restrict the use of examination and review reports to specified parties. We believe that a restriction on the use of an auditor's examination report is appropriate, given that general users of these reports may not have sufficient understanding of the subject matter to which they relate, i.e., the Financial Responsibility Rules.

The Proposed Examination Standard states that "because the broker's or dealer's assertions apply to each specified Financial Responsibility Rule, the auditor's examination should evaluate compliance with each specified Financial Responsibility Rule, and the effectiveness of internal control over compliance with each specified Financial Responsibility Rule individually."¹¹ We recommend that the Board clarify what type of modification could be made to the auditor's examination report if the broker-dealer was not compliant with one or more of the Financial Responsibility Rules but was compliant with others. We believe that providing examples of how an examination report should describe these situations would be informative.

Proposed Attestation Standard, Review Engagements Regarding Exemption Reports of Brokers and Dealers

SEC Proposed Rule 17a-5 would require broker-dealers that do not hold customer funds or securities to file a new report asserting their exemption from the requirements of Rule 15c3-3, accompanied by a review report from their independent registered public accountants based on management's assertion regarding such exemption.

Appropriateness of a review engagement

We do not believe a review engagement for a broker-dealer's assertion that it is exempt from the requirements of Rule 15c3-3 is appropriate. Specifically, we do not believe that inquiry and analytical procedures, the standard procedures performed in a review engagement, would provide sufficient evidence of a broker-dealer's assertion that it is exempt from the requirements of Rule 15c3-3.

In making this recommendation, we note that the PCAOB's interim attestation standards (AT section 601, Compliance Attestation) state that an auditor should not accept an engagement to perform a "review" level of service related to an entity's compliance with specified requirements, or an assertion thereon.¹² The Board is proposing to amend paragraph 7 of AT 601 to indicate that when an auditor is engaged to perform a review engagement on assertions made by a broker or dealer in an exemption report that is prepared pursuant to SEC Proposed Rule 17a-5, the auditor is to follow the requirements of the Proposed Review Standard. Notwithstanding the proposed amendment, we continue to believe that the scope of procedures contemplated by a review engagement is not sufficient to permit auditors to conclude, with a moderate level of assurance, that a broker-dealer's assertion that it is exempt from the requirements of Rule 15c3-3 is fairly stated.

¹¹ See Note to proposed paragraph 4 of the Proposed Examination Standard.

¹² See PCAOB interim attestation standard AT §601.07.

We further note the Board's requirement that an auditor that performs the review engagement but does not audit the broker-dealer's financial statements "must obtain knowledge of the evidence obtained and results of procedures performed in the audit of the financial statements and supplemental information that is commensurate with that of the auditor of the financial statements and supplemental information".¹³ We believe that requiring this level of knowledge, which is beyond what would be attained through inquiry and analytical procedures, is further evidence that a review-level engagement does not meet the Board's expectations.

Instead, we recommend requiring an agreed-upon procedures engagement (addressing the results of procedures specified by the SEC) related to a broker-dealer's exemption from the requirements of Rule 15c3-3. We also would support requiring an examination engagement, as contemplated by existing attestation standards, relating to such an assertion, if suitable criteria were developed for such an examination.

Time period for assessment

In our comment letter to the SEC, we request clarification about the time period for the assertion regarding exemption from the requirements of Rule 15c3-3 and indicate that we believe a point-in-time assertion would be sufficient. We believe that the Proposed Review Standard also should indicate whether the auditor's review of the Exemption Report is for an annual period or as of the broker-dealer's fiscal year-end, and we reiterate our belief that a point-in-time assertion would be sufficient.

Other

Our comments provided under the sections entitled *General requirements* and the *Auditor's examination report* under the Proposed Examination Standard also apply to the Proposed Review Standard.

Proposed Amendments to AS 7, Engagement Quality Review (EQR)

The Proposing Release includes amendments to AS 7 that would require "an engagement quality review and concurring approval of issuance for examination engagements and review engagements of broker-dealers."¹⁴ This requirement would apply to both the examination report required for carrying broker-dealers that file a Compliance Report and the review report required for non-carrying broker-dealers that are exempt from the Compliance Report requirement and file an Exemption Report.

AS 7 includes specific guidance on the EQR process for audit engagements and reviews of interim financial information.¹⁵ However, AS 7 does not include specific guidance for examination and review engagements under the attestation standards, nor do the Proposed Standards provide any amendments to AS 7 in this regard. We believe auditors would benefit from guidance on specific EQR procedures to be performed for examination and review engagements under the Proposed Standards.

¹³ See Note to paragraph 7 of the Proposed Review Standard.

¹⁴ See Section V. A. of the Proposing Release

¹⁵ See AS 7, paragraphs 9-18.

Proposed Amendments to AT 101 and AT 601

As indicated in the Proposing Release, the Proposed Standards are designed to tailor the PCAOB's attestation standards to the auditor's responsibilities under SEC Proposed Rule 17a-5. In the Proposed Standards, the Board outlines various requirements relating to supervision, risk assessments and materiality considerations. We believe AT 101 and AT 601 contain relevant and appropriate guidance that should be incorporated into the Proposed Standards. For example, the general standards of fieldwork in AT 101 and the considerations of attestation risk in an examination engagement, subsequent events and the work of an entity's internal audit function in AT 601 are more detailed than those provided in the Proposed Standards. Since the proposed amendments to AT 101 and AT 601 specifically scope out examinations of Compliance Reports and reviews of Exemption Reports,¹⁶ we recommend that the Board expand the guidance in the Proposed Standards to include the relevant sections in AT 101 (e.g., for the general standards of fieldwork including planning and supervision and obtaining sufficient evidence) and AT 601 (e.g., for considerations of attestation risk in an examination engagement, subsequent events and use of internal audit).

Lastly, we note that paragraphs 4.43-.45 of AT 9101 contain guidance for auditors about providing access to or copies of attest documentation to a regulator. We believe this guidance would be helpful to auditors of carrying or clearing broker-dealers subject to the access to audit documentation amendment outlined in SEC Proposed Rule 17a-5. We recommend that the Board add (either directly or via reference) the AT 9101 guidance to the Proposed Standards.

Conclusion

In summary, we generally support the objectives of the Proposed Examination Standard and believe it responds to the auditor requirements in SEC Proposed Rule 17a-5. At the same time, we encourage the PCAOB to clarify the elements of the Proposed Examination Standard discussed above to help facilitate consistent application in practice. We support the PCAOB's proposed effective date for the Proposed Standards and have recommended that the SEC align the effective date of its Proposed Rule 17a-5 with the Proposed Standards to give broker-dealers and their auditors time required to adequately address the final rules. We further encourage the PCAOB to consider requiring an agreed-upon procedures engagement or an examination engagement, rather than a review engagement, relative to a broker-dealer's assertion that it is exempt from Rule 15c3-3.

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We would be pleased to discuss our comments with the PCAOB or its staff at your convenience.

Very truly yours,

Ernst & Young LLP

¹⁶ See proposed paragraphs g and h to AT 101 and see proposed paragraph a to AT 601.