

## VIA ELECTRONIC MAIL

February 15, 2011

J. Gordon Seymour  
Office of the Secretary  
PCAOB  
1666 K Street, N.W.  
Washington, DC 20006

RE: Proposed Temporary Rule for an Interim Inspection Program for the Audits of Brokers and Dealers

Dear Mr. Seymour:

On December 14, 2010, the Public Company Accounting Oversight Board (PCAOB) published Release No. 2010-008, which proposes a temporary rule to establish an interim inspection program related to audits of brokers and dealers (Proposed Rule)<sup>1</sup>. The Proposed Rule would allow the Board to assess registered public accounting firms' current compliance with laws, rules, and standards in performing audits with respect to brokers and dealers. Moreover, it would inform the Board's decisions about significant elements of a permanent inspection program, including whether to differentiate among classes of brokers and dealers, whether to exempt any categories of public accounting firms, and what minimum inspection frequency schedules to establish.

The Financial Services Institute (FSI)<sup>2</sup> welcomes this opportunity to comment on the Proposed Rule. We believe that the interim inspection program contained in the Proposed Rule is premature and will add an unnecessary burden to introducing broker-dealers. We urge the PCAOB to collect and study all available data from the Securities and Exchange Commission (SEC), the Financial Industry Regulatory Authority (FINRA), the Securities Investor Protection Corporation (SIPC), industry experts, and industry associations before subjecting all public accounting firms that audit brokers and dealers to the interim inspection program. Our concerns are addressed in more detail below.

### Background on FSI Members

FSI represents independent broker-dealers (IBD) and the independent financial advisors that affiliate with them. The IBD community has been an important and active part of the lives of American investors for more than 30 years. The IBD business model focuses on comprehensive financial planning services and unbiased investment advice. IBD firms also share a number of other similar business characteristics. They generally clear their securities business on a fully disclosed basis; primarily engage in the sale of packaged products, such as mutual funds and

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<sup>1</sup> See Proposed Temporary Rule for an Interim Inspection Program for the Audits of Brokers and Dealers, PCAOB Release No. 2010-008 (Dec. 14, 2010), *available at*

[http://pcaobus.org/News/Releases/Pages/12142010\\_BrokerDealer.aspx](http://pcaobus.org/News/Releases/Pages/12142010_BrokerDealer.aspx)

<sup>2</sup> The Financial Services Institute is an advocacy organization for the financial services industry – the only one of its kind – FSI is the voice of independent broker-dealers and independent financial advisors in Washington, D.C. Established in January 2004, FSI's mission is to create a healthier regulatory environment for their members through aggressive and effective advocacy, education and public awareness. FSI represents more than 120 independent broker-dealers and more than 15,000 independent financial advisors, reaching more than 15 million households. FSI is headquartered in Atlanta, GA with an office in Washington, D.C.

variable insurance products; take a comprehensive approach to their clients' financial goals and objectives; and provide investment advisory services through either affiliated registered investment adviser firms or such firms owned by their registered representatives. Due to their unique business model, IBDs and their affiliated financial advisors are especially well positioned to provide middle-class Americans with the financial advice, products, and services necessary to achieve their financial goals and objectives.

In the U.S., approximately 201,000 financial advisors – or 64% percent of all practicing registered representatives – operate as self-employed independent contractors, rather than employees, of their affiliated broker-dealer firm.<sup>3</sup> These financial advisors provide comprehensive and affordable financial services that help millions of individuals, families, small businesses, associations, organizations, and retirement plans with financial education, planning, implementation, and investment monitoring. Clients of independent financial advisors are typically “main street America” – it is, in fact, almost part of the “charter” of the independent channel. The core market of advisors affiliated with IBDs is clients who have tens and hundreds of thousands as opposed to millions of dollars to invest. Independent financial advisors are entrepreneurial business owners who typically have strong ties, visibility, and individual name recognition within their communities and client base. Most of their new clients come through referrals from existing clients or other centers of influence.<sup>4</sup> Independent financial advisors get to know their clients personally and provide them investment advice in face-to-face meetings. Due to their close ties to the communities in which they operate their small businesses, we believe these financial advisors have a strong incentive to make the achievement of their clients' investment objectives their primary goal.

FSI is the advocacy organization for IBDs and independent financial advisors. Member firms formed FSI to improve their compliance efforts and promote the IBD business model. FSI is committed to preserving the valuable role that IBDs and independent advisors play in helping Americans plan for and achieve their financial goals. FSI's mission is to ensure our members operate in a regulatory environment that is fair and balanced. FSI's advocacy efforts on behalf of our members include industry surveys, research, and outreach to legislators, regulators, and policymakers. FSI also provides our members with an appropriate forum to share best practices in an effort to improve their compliance, operations, and marketing efforts.

#### Comments on the Proposed Rule

As stated above, FSI believes that the interim inspection program contained in the Proposed Rule is premature and will add an unnecessary burden to introducing broker-dealers. We urge the PCAOB to collect and study all available data from the SEC, FINRA, SIPC, industry experts, and industry associations before subjecting all public accounting firms that audit brokers and dealers to the interim inspection program. Our concerns are addressed in more detail below.

- **Premature Nature of the Interim Program** – On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)<sup>5</sup> was signed into law. Among other things, the Dodd-Frank Act amended various provisions of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act). These amendments gave the PCAOB oversight authority with respect to audits of brokers and dealers that are registered with the SEC. Specifically, the Dodd-Frank Act amendments provide the PCAOB with authority to carry

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<sup>3</sup> Cerulli Associates at <http://www.cerulli.com/>.

<sup>4</sup> These “centers of influence” may include lawyers, accountants, human resources managers, or other trusted advisors.

<sup>5</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law No: 111-20, *available at* [http://docs.house.gov/rules/finserv/111\\_hr4173\\_finsrvcr.pdf](http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf).

out the same oversight responsibilities it has with respect to issuer audits in connection with registered public accounting firms' audits of brokers and dealers.

As noted in the Release to the Proposed Rule, the Dodd-Frank Act does not prescribe a specific program of inspection of registered public accounting firms that provide audit reports for a broker or dealer. Rather, the Dodd-Frank Act authorizes the PCAOB to establish such a program by rule, and leaves to the PCAOB important questions concerning the elements of the program. Among other things, Section 104(a)(2) of the Sarbanes-Oxley Act, as amended, provides that, (1) in establishing the program, the Board may allow for differentiation among classes of brokers and dealers; (2) the PCAOB may consider whether differing inspection schedules would be appropriate with respect to auditors that issue audit reports only for brokers or dealers that do not receive, handle, or hold customer securities or cash or are not members of the Securities Investor Protection Corporation; and (3) if the PCAOB exempts any public accounting firm from such an inspection program, the firm would not be required to register.<sup>6</sup>

Under the authority granted to the PCAOB under this amendment, it has proposed a temporary rule that would establish an interim program of inspection related to audits of all brokers and dealers, regardless of the type of broker or dealer. FSI strongly urges the PCAOB to reconsider the Proposed Rule because requiring the auditors of introducing broker-dealers to be subject to the oversight of the PCAOB would significantly increase the cost of doing business for this segment of the securities industry without a corresponding improvement to investor protection.

An introducing broker-dealer accepts customers' orders but the orders are processed or "cleared" through another broker, known as a carrying broker. A carrying broker is a broker-dealer that holds customer accounts for introducing broker-dealers and is typically a clearing firm for introducing firms. The carrying broker-dealer receives payments and securities from the clients and handles record keeping for these accounts. In recognition of the risk inherent in entrusting a firm with custody of investor assets, the carrying broker is subject to Securities Exchange Act Rule 15c3-3 that includes requirements regarding establishing a customer reserve as well as specific requirements regarding possession and control of customer securities.<sup>7</sup> Introducing broker-dealers bring customer accounts and assets to a carrying or clearing broker-dealer for safekeeping. Because introducing broker-dealers do not hold customer assets, they generally do not have to comply with Rule 15c3-3.<sup>8</sup>

While introducing broker-dealers do have direct contact with investors, they do not represent a significant risk to convert client funds or securities to their own use. SEC and FINRA Rules prohibit them from having custody of customer funds.<sup>9</sup> In order to insure they do not obtain custody of investor funds and securities, introducing firms are required to have policies and procedures in place to make sure their client's funds are promptly

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<sup>6</sup> See Proposed Temporary Rule for an Interim Inspection Program for the Audits of Brokers and Dealers, PCAOB Release No. 2010-008, 4, citing Section 104(a)(2)(A) of the Act, as amended

<sup>7</sup> All brokers or dealers who do not meet the exemption requirements of Rule 15c3-3(k) are required to comply with Rule 15c3-3. Carrying brokers generally do not meet the exemption requirements of Rule 15c3-3(k).

<sup>8</sup> See Rule 15c3-3(k)(2)(ii), which indicates that provisions of Rule 15c3-3 are not applicable to an introducing broker or dealer.

<sup>9</sup> An introducing broker-dealer's FINRA Membership Agreement does not permit the firm to receive/hold customer funds or securities. See also, The Securities Exchange Act of 1934, Customer Protection Reserves and Custody of Securities, 17 C.F.R. § 240.15c3-3.

transmitted<sup>10</sup> to the clearing broker-dealer who holds the assets on behalf of the client.<sup>11</sup> These policies and procedures include the following:

- A prohibition on accepting cash or cash equivalent payments from clients,
- A prohibition on accepting checks made payable to the individual financial advisor,
- A prohibition on accepting checks made payable to the broker-dealer,
- Tracking and blottering all checks received, and
- Tracking and blottering all securities received.

While the risk to investors at introducing broker-dealers is low, the cost of audits by PCAOB registered and inspected accounting is significant. If introducing broker-dealers were required to have their auditors subject to PCAOB oversight, it would result in significant additional expense. Our members tell us that the cost of a financial audit would increase from \$5,000 to \$10,000 per year, to an estimated \$50,000 to \$100,000 per year for the typical introducing broker-dealer firm. Such a large increase would place a significant additional burden on small introducing broker-dealers and could potentially force them out of business. Those firms who can bear the additional costs will be forced to pass on the expense to the investor. In either case, the result is a decrease in access to professional financial advice and service.

Additionally, this substantial increase in costs will not improve investor protection because there are existing mechanisms in place to insure that conversion of client assets does not occur at introducing firms. For example, FINRA and the SEC examine more than half of the 4,570 registered broker-dealer firms each year.<sup>12</sup> These regulators test for compliance with federal securities laws, self-regulatory organization rules and compliance with the broker-dealers written supervisory procedures. Since the oversight examinations performed by FINRA and the SEC provide the necessary investor protection, PCAOB oversight of auditors of introducing broker-dealers is duplicative and unnecessary.

Accordingly, we believe that the PCAOB should further study the important distinction between an introducing broker-dealer and a carrying broker-dealer, prior to applying the interim program to all broker-dealers. We believe that the interim program should exclude introducing broker-dealers, and that further analysis and study should be conducted related to PCAOB oversight of introducing broker-dealers. Applying an expensive oversight program in an effort to better understand the current environment is not a prudent approach. We urge the PCAOB to rethink and revamp the contemplated interim program.

- **Mandatory Participation** – Page 8 of the Release announcing the Proposed Rule provides that “the proposed temporary rule would make cooperation with Board inspection procedures under the interim program mandatory for registered firms and their

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<sup>10</sup> See SEC Release No. 34-31511. “A broker or dealer is deemed to ‘promptly transmit’ all funds and to ‘promptly deliver’ all securities...where such transmission or delivery is made no later than noon of the next business day after the receipt of such funds or securities; provided, however, that such prompt transmission or delivery shall not be required to be effected prior to the settlement date for such transaction.”

<sup>11</sup> See generally, Rule 15c3-3(k)(2)(i) of the Securities Exchange Act of 1934, available at <http://www.law.uc.edu/CCL/34ActRls/rule15c3-3.html#k.2.i>.

<sup>12</sup> Rick Ketchum, Chairman & CEO of FINRA, before the NAVA Government & Regulatory Affairs Conference (June 8, 2009), available at <http://www.finra.org/Newsroom/speeches/Ketchum/P118889>.

associated persons.”<sup>13</sup> Moreover, Section 4 of Rule 4020T would make participation in the program mandatory for all broker-dealers.

FSI believes the Board should consider voluntary participation in the interim inspection program for auditors of introducing broker-dealer that are already subject to PCAOB oversight in an effort to assess the need for the participation of all introducing broker-dealers. We believe that this approach will serve the PCAOBs’ desire for additional information on introducing broker-dealer oversight, while reducing the cost and expense related to PCAOB oversight as contemplated in the interim program.

Moreover, FSI believes that there needs to be additional study of the merits of covering auditors of introducing broker-dealers in the interim program. We believe that the PCAOB should collect and study all available data from the SEC, FINRA, SIPC, industry experts, and industry associations before subjecting all categories of registered public accounting firms that audit brokers and dealers to the interim program. If the research indicates that auditors of introducing broker-dealers should be covered, the PCAOB can then issue a second rulemaking covering them, but not without collecting and studying the facts and performing a careful cost-benefit analysis first.

#### Conclusion

We are committed to constructive engagement in the regulatory process and, therefore, welcome the opportunity to comment on the Proposed Rule. As stated above, FSI believes that the interim program should be voluntary for introducing broker-dealers and that additional study should be completed on the merits of covering auditors of introducing broker-dealers in the interim program.

Thank you for your consideration of our comments. Should you have any questions, please contact me at 202 379-0943.

Respectfully submitted,



Dale E. Brown, CAE  
President & CEO

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<sup>13</sup> See Proposed Temporary Rule for an Interim Inspection Program for the Audits of Brokers and Dealers, PCAOB Release No. 2010-008, 8.