

# Securities Adviser

News and analysis for the securities and commodities industry July 2009

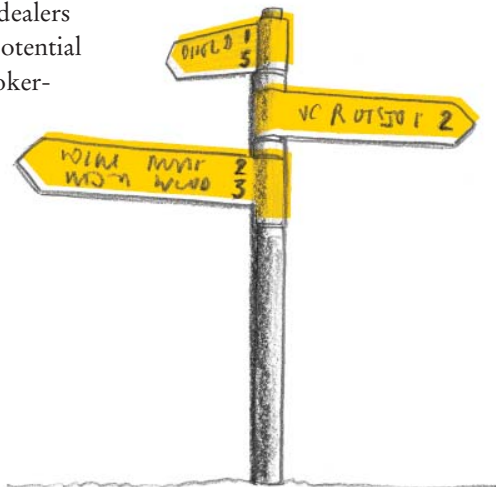
## Broker-dealers brace for changing environment

By Richard Flowers, Financial Services  
Audit partner

Business as usual is being redefined by the global financial crisis. The Obama administration and Congress are working to revamp the country's financial oversight system, from the *Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure* to the proposed resolution authority over "systemically important" financial firms. As regulators and investors demand reform and transparency, broker-dealers face a changing landscape. What potential changes are in store? How can broker-dealers prepare?

### Customer statements

The Financial Industry Regulatory Authority (FINRA) is considering a number of rule interpretations. Calls for clearer and more thorough information have prompted discussions about what should be included in customer statements and how they should be prepared and delivered. A point of contention is whether externally held assets should be included in statements as a service to customers.



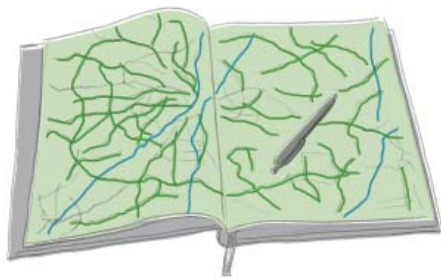
Some broker-dealers feel statements' existing disclosures are adequate, arguing that these externally held assets are clearly below the line and that reporting broker-dealers are not responsible for the accuracy of their valuations. Given the current environment, it is likely FINRA will push for improved due diligence, verification of the existence of assets and validation of the valuation methods used. The SEC has also expressed concern and is considering additional procedures for validation of customer assets. It has recently proposed amendments to the Rule 206(4)-2 (Custody Rule) under the Investment Advisers Act of 1940 and comments are due July 28, 2009. Under the proposed rules, investment advisers that have custody of client funds would be required to undergo an annual "surprise" examination by an independent public accountant. As qualified custodians for investment advisers, brokers may be subject to this requirement as well. Broker-dealers should be cognizant of these potential changes.

continued >

## Broker-dealers brace for changing environment (continued)

FINRA is also concerned with the accuracy and timeliness of information provided to customers. Rather than requiring clearing firms to prepare customer statements themselves, New York Stock Exchange Rule 409(a) permits introducing firms to prepare customer statements based upon clearing firms' records. This change of hands makes statements especially vulnerable to errors. Thus, FINRA has proposed Rule 2231, which would make the clearing firm responsible for preparing and transmitting statements to customers. In the meantime, clearing broker-dealers should ensure that adequate controls are in place if an introducing broker-dealer prepares customer statements, including considering a SAS 70 report.

In addition, FINRA has proposed new Rule 3150, under which introducing broker-dealers would not be permitted to hold account statements. Under existing rules, customer statements can only be delivered to other parties, such as attorneys and accountants, with written instructions. Modifications will be made to allow electronic delivery.



### Clearing deposits

Recently, broker-dealers have revised their clearing agreements to subordinate the clearing broker-dealer's claim to any termination penalty charged to the introducing broker (IB) (and subordinated to the IB's customers) that have been approved by the trustee appointed by the Securities Investor Protection Corporation, pursuant to the issuance of a protective decree under the Securities Investor Protection Act. IBs can continue to treat their clearing deposits as allowable assets in the determination of net capital, but these deposits must be refundable to the introducing broker-dealer within 30 calendar days plus five business days after the initial transfer. The SEC has expressed concern that clearing firms have been delaying the process of returning the clearing deposit when the transfer of customer assets encounters difficulties. If such restrictions remain in the current clearing agreement, the deposit will be a nonallowable asset from the inception of the clearing agreement.

Clearing broker-dealers have stated that they are willing to return the deposits, but maintain that the deposits are their only leverage in encouraging the introducing broker-dealer to provide information regarding assets that are difficult to transfer. However, most clearing broker-dealers have agreed to return a portion of the deposit based on the percentage of accounts that are successfully transferred. Another possible solution is applying a percentage haircut to the deposit.

### Use of customers' fully paid securities

As more programs that lend customers' fully paid securities are being developed, some observers are questioning who should notify customers of the risks associated with those programs. FINRA is contemplating assigning this responsibility to the clearing broker-dealer. The more important underlying issue is determining whether lending fully paid securities programs is in the best interests of customers — these securities are not ordinarily permitted unless the customer signs an agreement — and customers may not fully understand the risks involved.

### Rating agency conduct

Collateralized debt obligations and collateralized mortgage obligations are at the center of the rating agency issue. Agencies were rating portfolios as a whole rather than assessing the individual underlying assets. The SEC is proposing rules to help ensure that ratings are clearer for investors, including requiring additional transparency when it comes to credit rating histories. In addition, the proposed rules would prohibit issuing an issuer-paid credit rating unless information is made available to other nationally recognized statistical rating organizations.

### Credit default swaps

One reputed source of the economic downturn, credit default swaps (CDS) are now subject to review by a central counterparty or clearing facility to help control the risks associated with these vehicles. The Chicago Mercantile Exchange is now the third SEC-approved clearing firm for CDS.

continued>

## Broker-dealers brace for changing environment (continued)

### Auction-rate securities

Investors need better risk information regarding auction-rate securities (ARS). Many investors have incorrectly interpreted these securities as cash equivalents and have been unable to redeem them. In order to help customers maintain liquidity in these situations, FINRA has granted broker-dealers temporary relief from certain net capital and reserve formula rules.

### Money market mutual funds

Certain money market mutual funds halted redemptions when the net asset value dropped below \$1 per share. Broker-dealers were granted temporary relief from the maintenance margin and net capital requirements to provide programs to support customers. The questions arise: What is the broker-dealer's responsibility when it comes to supporting customers, and when does the customer bear the risk of securities trading?

### Enhanced reporting of TRACE-eligible securities

In an effort to increase transparency, the SEC recently proposed a rule that would broaden the range of securities included in the Trade Reporting and Compliance Engine (TRACE), such as corporate debt securities that are eligible for public sale.

### Failed Treasury positions

The SEC recently approved a rule to impose a charge on failed Treasury positions to address the ongoing settlement failures in Treasury securities transactions. Effective May 1, 2009, the Government Securities Division (GSD) of the Fixed Income Clearing Corporation instituted a monetary charge equal to the product of net money due and 3 percent per annum minus the Fed Funds Target Rate that is effective on the business day prior to the originally scheduled settlement date. The charge will be capped at 3 percent per annum and will be applied daily as a debt on the member's monthly GSD bill, or as a credit for those with fail-to-receive positions. Since the penalty charge has been introduced, the rate of failures has dropped substantially.

In the face of so many emerging issues, broker-dealers must be vigilant about complying with requirements as they arise. Broker-dealers will need to develop a compliance infrastructure and enhanced risk management procedures. Those that proactively renew their focus on strengthening risk controls and improving disclosures to investors will be better prepared to meet heightened expectations and may even help restore much-needed confidence. •

### About the newsletter

*SecuritiesAdviser* is published quarterly by Grant Thornton LLP. The people in the independent firms of Grant Thornton International Ltd provide personalized attention and the highest quality service to public and private clients in more than 100 countries. Grant Thornton LLP is the U.S. member firm of Grant Thornton International Ltd, one of the six global audit, tax and advisory organizations. Grant Thornton International Ltd and its member firms are not a worldwide partnership, as each member firm is a separate and distinct legal entity.

For additional information on the Financial Services practice, contact Jack Katz, national managing partner of Financial Services, at [Jack.Katz@gt.com](mailto:Jack.Katz@gt.com).

To subscribe to *SecuritiesAdviser*, fill out the online request form at [www.GrantThornton.com/securitiesadviser](http://www.GrantThornton.com/securitiesadviser).

### Contact information

**Cynthia Keveney**  
National Marketing Director  
Financial Services  
[Cynthia.Keveney@gt.com](mailto:Cynthia.Keveney@gt.com)

Editor: Emily Ford  
[FinancialServices@gt.com](mailto:FinancialServices@gt.com)

© Grant Thornton LLP  
All rights reserved  
U.S. member firm of Grant Thornton International Ltd

[www.GrantThornton.com](http://www.GrantThornton.com)

Content in this publication is not intended to answer specific questions or suggest suitability of action in a particular case. For additional information on the issues discussed, consult a Grant Thornton client service partner.