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Securities and Exchange Commission
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Broker-Dealer Reports

Dear Securities and Exchange Commission:

This is the first of two letters I am submitting on this proposed rule, Broker Dealer Reports. Among other things, this proposal requires broker-dealers to file a new set of reports with the Commission, including audited Compliance Reports along with Examination Reports regarding the effectiveness of various controls. The proposed compliance process appears to be extremely inefficient. There are better processes that can be set up that would save both the Commission and the industry substantial resources while achieving better results.

My comments are in brief:

- Extreme care must be taken to make sure that the proposed compliance audits do not devolve into a Sarbanes-Oxley level of overkill. Despite protestations to the contrary in the proposing release, this is s huge risk.

[1] I am also on the boards of directors of the EDGA and EDGX stock exchanges. My comments are strictly my own and don't necessarily represent those of Georgetown University, EDGX, EDGA, or anyone else for that matter.

- The Compliance Reports are redundant if FINRA is doing its job. If FINRA isn't, the SEC should be taking more serious action.
- All of these proposed forms should be filed electronically, without the need for multiple redundant paper copies.
- The Exemption Report should be just a check box on the FOCUS report.
- Let SIPC take care of its own information needs by giving them access to Commission databases rather than requiring 5,000 BDs to send more paper to SIPC.
- The RIA section of the proposed Form Custody is mostly redundant of Form ADV
- Required levels of attestation and frequency of Compliance Reports should be on a risk-based system.
- The Commission should "beta-test" new regulatory processes just as private companies beta-test new products.
- There is no discussion of how other jurisdictions deal with broker-dealer reports and audits. We should learn from others what works best.

Extreme care must be taken to make sure that the proposed compliance audits do not devolve into a Sarbanes-Oxley level of overkill.

The new rules explicitly require the independent accountants to opine "whether internal control over compliance with the Financial Responsibility Rules was effective during the most recent fiscal year such that there were no instances of material weakness"[2] Hmm, this looks, smells, and tastes so similar to the infamous Sarbanes Oxley requirements that it will be very hard for the accounting profession to require anything less than a full-blown Sarbanes-Oxley process before they are willing to sign off on the report.[3] This will be far more expensive than the guesstimates contained in the cost estimates.

The proposing release explicitly states on page 17:

"The Commission is not proposing that effectiveness of internal control over financial reporting be included as one of the assertions made by the broker-dealer in the Compliance Report."

While technically accurate, this statement is misleading. The Commission is proposing that effectiveness over compliance be included as one of the attestations made in by the broker-dealer in the Compliance report. Unless the Commission takes great care to express what is meant by "effectiveness" and how it is to be examined, this could turn into an extremely costly audit process with little value added to society.

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

[3] Section 404 of Sarbanes Oxley required that the internal control report *"contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting."*

The Commission badly underestimated the cost of Sarbanes-Oxley 404 compliance and I fear that the Commission is badly underestimating the cost of compliance with this proposal.

Isn't FINRA already doing compliance examinations?

Speaking of compliance audits, isn't it the job of FINRA to examine broker-dealers for compliance with these rules? If FINRA is doing its job, which I believe it is, then the proposed audited Compliance audits are a redundant waste of resources for both the registrants and the SEC. If FINRA is not doing its job, then the SEC should address the problem head on with an explicit investigation into FINRA's performance. External compliance audits by independent auditors might make good sense if FINRA was not examining the firms, but it seems like needless duplication of effort with little additional protection for consumers.

Why so much paper? These forms should all be filed only once, and electronically at that.

The proposal makes several references to filing multiple paper copies with multiple entities. This will result in the needless slaughter of innocent trees and the waste of taxpayer and industry resources. It would be much more efficient for the information to be filed electronically with the Commission, and then give electronic access to SIPC, FINRA, and the regional offices. This will result in much better efficiency within the SEC as well as reduce costs to the registrants. Since new forms are being proposed here, it makes sense to start the process with electronic filing (perhaps as part of FINRA's e-FOCUS) rather than add it as an afterthought later.

For example, footnote 166 on page 80 states:

"As previously discussed, the Commission proposes to amend paragraph (d)(6) of Rule 17a-5 to require that a copy of the annual report be filed with SIPC. Specifically, the Commission proposes that paragraph (d)(6) provide that the annual reports shall "be filed at the regional office of the Commission for the region in which the broker or dealer has its principal place of business, the Commission's principal office in Washington, D.C., and the principal office of the designated examining authority for said broker or dealer and with the Securities Investor Protection Corporation. Copies thereof shall be provided to all self-regulatory organizations of which said broker or dealer is a member, unless the self-regulatory organization by rule waives this requirement."

Why manual signatures? The Commission should pay attention to E-SIGN

Likewise, page 130 of the proposing release states:

> "The broker or dealer must file three copies of the notice and the accountant's letter, one copy of which must be manually signed by the sole proprietor, or a general partner or a duly authorized corporate officer, as appropriate, and by the independent public accountant, respectively."

The demand for manual signatures flies in the face of Congressional intent in the Electronic Signatures in Global and National Commerce (E-SIGN) act.[4] As these submissions should all be done electronically, requiring a manual signature is a step backwards. With the limitations on the SEC budget, the agency cannot afford to wallow in paper and must take every possible step to gather and store the information electronically.

The frequency and degree of attestation of Compliance Reports should be risk-based.

If one assumes that Compliance Reports are necessary (and not redundant to what FINRA does), then the Commission should also think more carefully about the frequency of these expensive audited reports and the level of attestation required in them.. Just as there are different levels of accounting firm engagement, there can be different levels of the Compliance Report. Less risky firms could have a less expensive "review" as opposed to an audit in between full blown audits.

As different firms present different levels of risk, it makes sense to require such reports based on the different risk levels. For example, the Commission might classify firms as follows

Lowest risk: One low-level "review" every three years, and one Compliance Report every six years.
Medium risk: One Compliance Report every three years.
High Risk: One Compliance Report every year.
For cause: Commission could demand a Compliance Report on short notice for firms that exhibit various red flags such as customer complaints .

The proposing release pays no attention to the optimal frequency of such reports.

Shouldn't the Exemption Report be just one check box on the FOCUS report?

The amount of paperwork involved for small firms that do not carry customer securities seems rather excessive. It would be quite easy for FINRA to check that this is indeed the case when FINRA examines a firm. I don't see the added benefit from the auditor attestation here.

Aren't the RIA disclosure requirements redundant of Form ADV?

Although the introduction to the proposing release makes it sound that it is reducing paperwork for broker-dealers that are also RIAs, I don't understand how that works by reading the proposal. Indeed, it appears that broker-dealers who are also RIAs are required to file additional information on the form, much of which is duplicative of the information required on Form ADV.

The Commission should "beta-test" new regulatory products just as private companies beta-test new products.

The current rulemaking is an example of a fairly typical SEC rulemaking process: Rules are proposed, comments are received, and then a final rule is issued. A better approach would be to learn from the

[4] Public Law 106-229, June 30, 2000.

methods that private industry uses to launch a new or modified product. Usually a new product goes through a "beta" test phase where it is tested by real customers in actual use before it is rolled out to the marketplace. The beta testing phase catches problems that were not anticipated in the design phase, and provides the opportunity to fix the problems before production is scaled up. The traditional SEC rulemaking process does not go through such a live test, but instead relies solely on the comment period to refine the proposals. The closest that the Commission comes to a real beta test is to the process used for developing XBRL filings and its staggered implementation. This should be done for more new regulations like the ones proposed here.

Occasionally the Commission has engaged in specific pilot experiments, as it did with Regulation SHO. The Reg SHO pilot was an excellent example of how to make policy based on good information.

Among other things, this rulemaking requires additional new processes, such as independent compliance audits of broker dealers. I suspect that there will be many implementation questions that will arise regarding the scope, cost, application, and the usefulness of these new processes. It appears that most of the cost-benefit analysis is simple guesswork, based more on intuition than hard facts.

A better process would be to explicitly conduct a beta test of the new process by requiring a subset of firms (scientifically chosen for proper analysis) to file the proposed reports, and then look at the cost both to the pilot firms as well as at how the information is used within the SEC, FINRA, PCAOB, and SIPC. The results of the beta test will then be used to make sure that the right information is collected and distributed to the right people in the most efficient way.

Section 912 of the recent Dodd-Frank legislation clarifies that the Commission has the power to gather information with regard to proposed rulemakings without triggering the "collection of information" requirements of the Paperwork Reduction Act.[5] Furthermore, the Commission can engage academics and

[5] Specifically, the law states:

SEC. 912. CLARIFICATION OF AUTHORITY OF THE COMMISSION TO ENGAGE IN INVESTOR TESTING.
Section 19 of the Securities Act of 1933 (15 U.S.C. 77s) is amended by adding at the end the following:
''(e) EVALUATION OF RULES OR PROGRAMS.—For the purpose of evaluating any rule or program of the Commission issued or carried out under any provision of the securities laws, as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), and the purposes of considering, proposing, adopting, or engaging in any such rule or program or developing new rules or programs, the Commission may—
''(1) gather information from and communicate with investors or other members of the public;
''(2) engage in such temporary investor testing programs as the Commission determines are in the public interest or would protect investors; and
''(3) consult with academics and consultants, as necessary to carry out this subsection.
''(f) RULE OF CONSTRUCTION.—For purposes of the Paperwork Reduction Act (44 U.S.C. 3501 et seq.), any action taken under subsection (e) shall not be construed to be a collection of information.''.

consultants as well as "engage in such temporary investor testing programs as the Commission determines are in the public interest or would protect investors;"[6]

If you have any questions, feel free to email me at angelj@georgetown.edu or call me at (202) 687-3765.

Respectfully submitted,

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[6] One could quibble about whether a beta test involving broker-dealers would count as a "temporary investor testing program" under this section. I believe it does. Broker-dealers are also investors in that they generally own securities.