

**RELEASE NO. 79**

April 8, 1958

**SECURITIES ACT OF 1933**

Release No. 3916

**SECURITIES EXCHANGE ACT OF 1934**

Release No. 5671

**HOLDING COMPANY ACT OF 1935**

Release No. 13720

**INVESTMENT COMPANY ACT OF 1940**

Release No. 2693

**Amendment of Rule 2-01 of Regulation S-X**

On January 28, 1958, the Securities and Exchange Commission announced that it had under consideration certain proposed amendments to Rule 2-01 of Regulation S-X (see Securities Act Release No. 3933). The Commission has considered all of the views and comments received on the proposals and has adopted the amendments in the form stated below.

**Purpose of Amendment**

When the Committee on Banking and Currency of the U. S. Senate was holding hearings on the Securities Act of 1933, a representative of the accounting profession appeared before the Committee and suggested requiring certification by independent public accountants of financial statements included in the registration statements under the Act. The committee considered at some length whether the additional expense to industry of having an impartial audit by accountants independent of the company and management was justified by the expected benefits to the investor and the public. The proposal to require certification by independent public accountants was incorporated in the principal statutes administered by this Commission, either as a requirement or as authority to require certification.

The Commission in the past has considered that relationships such as promoter, underwriter, voting trustee, director, officer, and employee of, and ownership of any direct or indirect financial interest in, the registrant or any affiliate thereof were incompatible with the independent status of a certifying accountant. The Commission has therefore refused to recognize an accountant as independent with respect to any person with whom he has any one of these relationships. Since certification by an independent accountant is required because of the value of an independent

review, we believe that the prohibition of these relationships is justified and should be continued. However, in the ascertainment of whether accountants or members of their families have entered into one of these relationships with remote affiliates of the persons whose statements are being certified, and whether, in some instances, they hold indirectly any financial interest in the registrant or any of its parents or subsidiaries, there is an area in which some latitude for judgment is necessary in order to avoid undue hardship and expense to registrants and to accounting firms having a widespread accounting practice or whose clients have numerous affiliates. We have therefore revised the rule to permit the application of a test of materiality to these borderline areas. The change in the rule does not permit any of these relationships with close affiliates as we consider such relationships to prejudice materially the independent status of an accountant.

Situations arise in which it is not necessary to make a finding of lack of independence even though an accountant may have held a financial interest during the period of report but at a time when his independence was not a factor. For example, an accountant may be called upon to furnish a certificate in a registration statement for a former client in whom he now has a financial interest but with whom he maintained an independent relationship during the period covered by the audit and up to the date he issued his original certificate. Another example is where an accountant held stock in a company for which he had never had an engagement but sold it upon accepting an engagement. In these and other situations where it is clear from the facts that the independent status of the accountant is not prejudiced by a particular relationship, we will upon request advise the accountant that no action will be taken because of this relationship.

The rule has also been revised to make it clear that where the relationships described in the rule exist the Commission finds that an accountant is in fact not independent with respect to the company involved but does not find that he is in fact independent in instances where it fails to find that one of these relationships exists.

These revisions give formal recognition to administrative practices which have been in the process of development for some time. They make no material change in the policy as enumerated in prior decisions of the Commission and in published opinions of the Chief Accountant.

#### **Text of Amendment of Rule**

The amendments are in the form of a revision of paragraphs (b) and (c) of Rule 2-01. The paragraphs as amended read as follows:

“(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents or subsidiaries in whom he has, or had during the period of report, any direct financial interest or any material indirect financial interest; or with whom he is, or was during such period, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

“(c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.”

#### **Statutory Basis**

The foregoing action is taken pursuant to the Securities Act of 1933, particularly Sections 6, 7, 8, 10 and 19(a) thereof, the Securities Exchange Act of 1934, particularly Sections 12, 13, 15(d) and 23(a) thereof, the Public Utility Holding Company Act of 1935, particularly Sections 5(b), 14, and 20(a) thereof, and the Investment Company Act of 1940, particularly Sections 8, 30, 31(c) and 38(a) thereof.

Since the revision clarifies the rule to reflect interpretations now in effect, it shall become effective April 8, 1958.

By the Commission.

ORVAL L. DUBOIS,

*Secretary.*

### **RELEASE NO. 80\***

August 19, 1958

**SECURITIES ACT OF 1933**  
Release No. 3956

**PUBLIC UTILITY HOLDING COMPANY ACT  
OF 1935**  
Release No. 13805

**SECURITIES EXCHANGE ACT OF 1934**  
Release No. 5759

**INVESTMENT COMPANY ACT OF 1940**  
Release No. 2757

**Amendment to Rule 1-01 of Article 1 and Rule 5A-01 of Article 5A of Regulation S-X**

\* Text of release omitted.

**RELEASE NO. 81**

December 11, 1958

**SECURITIES ACT OF 1933**  
Release No. 4002

**SECURITIES EXCHANGE ACT OF 1934**  
Release No. 5829

**PUBLIC UTILITY HOLDING COMPANY ACT  
OF 1935**  
Release No. 13877

**INVESTMENT COMPANY ACT OF 1940**  
Release No. 2801

**Independence of Certifying Accountants—Compilation of Representative Administrative Rulings in cases involving the Independence of Accountants**

The Securities and Exchange Commission today announced the publication of an additional release in its Accounting Series dealing with independence of accountants. This release, which summarizes cases in the Commission's experience under the independence rule<sup>1</sup> since the publication of Accounting Series Release No. 47 on January 25, 1944, (see p. 60 of this publication), together with prior releases and Commission decisions reflects the development of policy regarding the practice of accountants before the Commission over a period of some 25 years. See Appendix to this release.

The various laws administered by the Commission either require or give the Commission power to require that financial statements filed with it be certified by independent accountants, and with minor exceptions the Commission's rules require that such statements be so certified. The concept of independence was well developed and the value of a review by independent accountants who are in no way connected with the business was established before the passage of the first Act now administered by the Commission—the Securities Act of 1933.

The passage of the Securities Act, however, is an important landmark in the development of the concept of the responsibility of the independent accountant to the investor and the public. The original draft of the Securities Act did not require certification by independent accountants. A representative of the accounting profession appeared at the hearings on the bill before the Committee on Banking and Currency of the U.S. Senate to

suggest revisions of the bill.<sup>2</sup> He pointed out that the bill as drafted imposed "highly technical responsibilities upon the Commission as to accounting principles, their proper application and their clear expression in financial statements," and suggested the bill be revised to require that "the accounts pertaining to such balance sheet, statement of income and surplus shall have been examined by an independent accountant and his report shall present his certificate wherein he shall express his opinion as to the correctness of the assets, liabilities, reserves, capital and surplus as of the balance sheet date and also the income statement for the period indicated."

The committee considered at length the value to investors and to the public of an audit by accountants not connected with the company or management and whether the additional expense to industry of an audit by independent accountants was justified by the expected benefits to the public. The committee also considered the advisability and feasibility of requiring the audit to be made by accountants on the staff of the agency administering the Act.

In the report on the bill the Senate committee stated that it was intended that those responsible for the administration and enforcement of the law should have full and adequate authority to procure whatever information might be necessary in carrying out the provisions of the bill, but it was deemed essential to refrain from placing upon

<sup>1</sup> Rule 2-01 of Regulation S-X.

<sup>2</sup> Statement of Col. A. H. Carter, President of the New York State Society of Certified Public Accountants, before the Committee on Banking and Currency, U.S. Senate, 73d Cong., 1st Sess., on S. 875, p. 55.

any Federal agency the duty of passing judgment upon the soundness of any security.<sup>3</sup> The proposal to require certification by independent public accountants was incorporated in the bill as passed.

The requirement that industry furnish financial statements certified by independent accountants imposes upon the Commission the responsibility of ascertaining whether audits pursuant to its requirements are made by qualified independent accountants. Rule II(e) of the Commission's Rules of Practice and Rule 2-01 of Regulation S-X reflect this concern. Under Rule II(e) the Commission may disqualify, and deny, temporarily or permanently, the privilege of appearing or practicing before it to any accountant who is found by the Commission after hearing in the matter not to possess the requisite qualifications to represent others; or to be lacking in character or integrity; or to have engaged in unethical or improper professional conduct. These proceedings are conducted privately and may or may not result in a published opinion. They have been rare. Day-to-day problems arising under Rule 2-01 of Regulation S-X are largely concerned with determining whether particular relationships are of a nature which would prejudice the independent status of an accountant with respect to a particular client.

In administering Rule 2-01 the Commission has not attempted to set up objective standards for measuring the qualifications of accountants other than requiring that they be in good standing and entitled to practice as independent accountants in their place of residence or principal office. However, it is expected that they will have adequate technical training and proficiency and will conduct their audit in a workmanlike manner in accordance with generally accepted auditing standards.<sup>4</sup> Rule II(e) of the Rules of Practice recognizes that ethical and professional responsibility is founded upon character and integrity.

As stated in Accounting Series Release No. 47, the Commission has consistently held that the question of independence is one of fact, to be determined in the light of all the pertinent circumstances in a particular case, but it has not been practicable to identify all the circum-

stances which might prevent an accountant from being independent. However, in Rule 2-01(b) of Regulation S-X, as recently revised<sup>5</sup> to recognize the increasing complexities in the business world, the Commission has stated that "... an accountant will be considered not independent with respect to any person or any of its parents or subsidiaries in whom he has, or had during the period of report, any direct financial interest or any material indirect financial interest; or with whom he is, or was during such period, connected as a promoter, underwriter, voting trustee, director, officer, or employee." In connection with this revision practicing accountants indicated that an interpretive release similar to Accounting Series Release No. 47 would be a helpful guide to the profession. This release therefore summarizes previously unpublished rulings on independence which have arisen under the several Acts administered by the Commission. A finding in a particular case that an accountant is not independent under our rules does not necessarily reflect on his professional standing or qualification to serve other registrants with the Commission.

In Accounting Series Release No. 47 it was said that it was not feasible to present adequately in summarized form the circumstances existing in particular cases in which it was determined not to question an accountant's independence. The growth of the accounting profession since 1944 and the number of inquiries received from public accountants unfamiliar with the rules suggest the need for publication of rulings in this category.

Administrative rulings in this area have been reviewed and there are stated briefly herein the relationships which existed in select cases where an accountant was not denied the right to certify the financial statements because under the circumstances it was concluded that the independence of the accountant was not prejudiced. It is emphasized that these rulings were made after taking into consideration all known relevant circumstances and under changed circumstances the relationships stated in some of these examples could be disqualifying. Appropriate procedure in all cases where any doubt exists is to discuss the facts with the staff.

The following examples have been selected as

<sup>3</sup> Senate Report No. 47, 73d Cong., 1st Sess., p. 2.

<sup>4</sup> See Rule 2-02 of Regulation S-X.

<sup>5</sup> Accounting Series Release No. 79, Apr. 8, 1958. (See p. 194.)

representative of administrative rulings in specific cases:

#### NOT INDEPENDENT

Representative situations in which accountants have been held to be not independent with respect to a particular client:

### I. Relationships Specified in Rule 2-01(b) of Regulation S-X

#### A. Financial Interest

1. An accountant took an option for shares of his client's common stock in settlement of his fee. The option subsequently appreciated in value. The question of independence arose in connection with a proposed merger and application for listing on a national securities exchange.

2. Chartered accountants for a proposed registrant, a foreign corporation, owned a stock interest in the company.

3. Company A proposed filing a registration statement for a securities issue, part of the proceeds of which were to be used to acquire the assets of Company B. The certificate of the accountants of Company B could not be accepted for inclusion in the registration statement because a partner of the firm owned stock of Company B.

4. Using their own funds, the wives of partners in an accounting firm purchased stock in a client of the firm immediately prior to registration.

5. Shares of stock in a proposed registrant held by an accountant's wife had originally been received by him in settlement of his audit fee.

6. Partners and staff members of a small accounting firm which had certified the financial statements included in a registration statement subsequently acquired shares of stock of the registrant. They were denied the privilege of certifying subsequent financial statements to be included in a post-effective amendment to the registration statement.

7. An interpretation was given that the S.E.C. does not recognize a difference between a corporation and a registered investment company which would permit the ownership of shares in the latter by the accountant certifying its financial statements filed with the Commission.

8. After the issuance of an offering circular, some partners of the accounting firm which had certified the financial statements acquired shares

of the company. In connection with a subsequent listing application the registrant was advised that the accountants had lost their independent status.

#### B. Director, Officer, Employee

9. From the time of organization of a proposed registrant in November 1952 until July 1954, an accountant served as assistant treasurer, comptroller and director with the responsibility of keeping the accounts of the company and also acted as co-signer of checks. He also owned shares of the registrant's common stock. In July 1954 arrangements were made for an issue of securities. Even though the accountant severed his affiliation with the company as officer and director and made a gift of his shares of stock to his daughter, his certificate was not acceptable.

10. A partner in the firm of certifying accountants was a director of a proposed registrant, a stockholder, and a trustee of a testamentary trust which controlled a substantial portion of the registrant's stock. Even though he were to resign as director and trustee and dispose of his stock interest, the accounting firm could not be considered independent in connection with the proposed registration. It was also held that another partner of the accounting firm acting individually and apart from the firm could not be considered independent.

11. A partner in an accounting firm acted as controller and exercised some supervisory powers with respect to the proposed registrant's accounting procedures.

12. Financial statements for the first 2 years of the 3-year period required to be included in a registration statement had been certified by an individual practitioner who gave up his practice to become an executive of the registrant.

### II. Other Relationships and Conditions Resulting in Lack of Independence

13. An accountant who certified the financial statements of a registrant was the father of the secretary-treasurer of the registrant who was employed by the registrant on a half-time basis. Prior thereto, the secretary-treasurer had been employed by the registrant as its full-time principal accounting officer.

14. The wife of a partner of the accounting firm certifying the financial statements of an in-

vestment company was secretary-treasurer of the company.

15. A partner of an accounting firm was the brother of the holder of 50 percent of the stock of proposed registrant. The accountant was also counsel for the company, and his wife held \$35,000 of its preferred stock. The audit of the registrant's accounts was to be made by a branch office of the accounting firm in which the partner had only a financial interest.

16. The wife of the accountant who had certified the financial statements of a proposed registrant was the sister of the widow of the founder of the company. The widow had inherited 60 percent of the company's stock from her husband and her son 10 percent.

17. An accounting firm which certified the financial statements of a registered investment company had exclusive custody of the key to the company's safe deposit box. Under these conditions the accountants were acting as custodian of the securities portfolio and were in the position of auditing their own work.

18. An accountant and five persons who were the sole stockholders of the proposed registrant acquired a parcel of real estate for the purpose of selling or leasing it to the company. The total purchase price was \$85,000, of which \$26,000 was paid in cash and the balance by a note secured by a mortgage. In addition to providing his portion of the cash payment, the accountant loaned the others \$21,000 on interest bearing notes to cover their share of the down payment. It was also provided that the accountant would receive 25 percent of any profit arising from sale of the property to an outsider.

19. A certifying accountant, together with certain officers of the registrant, organized a corporation which purchased property from the registrant for \$100,000 giving the registrant \$25,000 cash and a purchase money mortgage for \$75,000.

20. Accountants were advised that they would lose their independent status if a trust created by partners and their wives purchased a building occupied by a client under a 21-year lease. The building was owned by an unrelated person and the transaction would have involved a substantial sum of money.

21. The partners of an accounting firm were considering investing in a finance company which operated a wholly-owned insurance agency to ar-

range insurance on the property financed. It was contemplated that a substantial part of such insurance would be placed with an insurance company client of the accounting firm. They were advised that if the insurance was so placed they would not be considered independent with respect to their client.

22. Two of the partners of the accounting firm certifying the financial statements of a registrant were also partners of a law firm engaged by the registrant to pass upon the legality of the securities which were being registered.

23. A certified public accountant who was also a lawyer practiced both professions as a partner in separate accounting and law firms. Both firms were approached by an investment company to accept engagements in their respective fields.

24. The wife of an accountant had a 47½ percent interest in one of the three principal underwriters of a proposed issue by the registrant.

25. A partner of an accounting firm acted as one of three executors of the will of a principal officer of a registrant and as one of three trustees of a trust established under the will. The principal asset of the trust was a substantial proportion of the voting stock of the registrant.

26. A partner in an accounting firm which audited registrant's accounts was appointed agent in control of certain buildings by the trustee for the children of the controlling stockholder of the registrant. In such capacity the accountant negotiated a lease with the registrant which occupied office space in one of the buildings. The partner in the accounting firm also acted as trustee of a trust for the benefit of the wife and children of the controlling stockholder.

#### NO ACTION

Representative situations in which accountants have not been held to be not independent with respect to a particular client:

#### I. Relationships Specified in Rule 2-01(d) of Regulation S-X

##### A. Financial Interest

27. A large national accounting firm had certified the financial statements covering the first 8 years of a 10-year summary of earnings to be included in a registration statement. Another firm of accountants certified the last 2 years. At

the time of their last certificate, 2 years earlier, there was no indication that the former firm was not in full compliance with the independence rule. It was deemed unnecessary for the firm to circularize the partners to determine whether any had subsequently acquired stock in the registrant.

28. Members of an accounting firm acquired shares of stock of a company controlled by one of their clients, an individual. The accounting firm had never done any work for the company. Upon being engaged to certify financial statements of the company in connection with a proposed registration, they immediately sold their holdings.

29. An accounting firm was held to be not independent because the wife of a partner owned stock in the registrant which had been acquired out of community earnings, and another accounting firm was engaged to audit the years in question. The wife disposed of the stock, and the firm was told that no objection would be raised to their certifying in subsequent years.

30. An accounting firm and the individual practitioner who preceded it had audited the accounts of proposed registrant since 1949. At various times between 1954 and 1957, a partner and an employee on the audit each acquired small amounts of issues of debenture bonds and subordinated notes. The securities held by these persons were redeemed by the company in August 1957 prior to certification of financial statements to be used in a proposed registration statement.

31. The following interpretations of the independence rule were given to an accounting firm which submitted two hypothetical situations:

(a) Company A proposed to file a registration statement and merge with or acquire Company X, which has been entirely independent of Company A. Financial statements of each company certified by different accounting firms were to be included in the the registration statement.

In this situation if partners of the firm of accountants for Company X had a financial interest in Company A, that accounting firm could be considered independent for the purpose of certifying the statements of Company X to be included in a registration statement filed by Company A. This conclusion assumes that Company A's shares are widely held and the partners' interest is similar to any public investor's.

A different conclusion would be indicated if the partners of the accounting firm were in a position to influence the action of Company A.

If Company X were to continue as a subsidiary of Company A, the accounting firm would not be considered independent for subsequent audits unless the partners of the firm promptly disposed of their financial interest in Company A.

(b) In a situation similar to that described above the accounting firm which had certified the statements of Company A generally would have no knowledge of the investments of its partners in nonclient corporations such as Company X. In some large national accounting firms the determination of such holdings can be a time-consuming and burdensome task. Under these circumstances Item 24 of the requirements of a registration statement under the Securities Act of 1933 (disclosure of relationships between registrant and experts whose opinions are included in the registration statement) may be answered in the negative with a disclaimer of knowledge as to whether or not the certifying accountants of Company A had any interest in Company X.

#### B. Director, Officer, Employee

32. A partner of an accounting firm was a director and member of the executive committee of a company for 6 years. In the year following his resignation the firm was engaged to certify the company's financial statements, but the audit did not cover any of the time during which the accountant served as a director.

33. A partner of an accounting firm who held shares of a registrant's stock was elected a director. Eight days later he was notified of his firm's appointment as accountants for the current year. He never attended any meetings of the Board of Directors and did not participate in the selection of his firm. Upon being notified of the appointment of his firm as accountants he immediately resigned his directorship and sold his stock.

34. Company A acquired Company B in January 1955. Financial statements of Company A for years ended June 30, 1954, and prior and financial statements of Company B for the year ended July 31, 1952, had been certified by accounting firm X. Financial statements of both companies for

subsequent years were certified by accounting firm Y. After completion of the last audits of the respective companies by accounting firm X, a partner of that firm became a director of each company. The statements certified by accounting firm X were accepted for inclusion in a registration statement of Company A because the accountants were independent at the time of their certification and more recent audits were made by accounting firm Y.

35. An accountant had certified the financial statements of a prospective registrant for 12 years prior to its consolidation with another company in February 1957. After completion of the 1956 audit his services were terminated. At the time of certification he was independent in all respects. In May 1957, the accountant was elected to the Board of Directors and thereafter purchased shares of the common stock of the company. Late in 1957 the company proposed filing a registration statement which would include certified financial statements of the last 3 years examined by the accountant and a subsequent period to be certified by another accountant.

36. An accounting firm took into its partnership an individual who had been vice president and comptroller of one of their clients. The individual's resignation from the registrant and affiliation with the accounting firm would occur subsequent to the filing of the registrant's annual report on Form 10-K but before the designation of auditors for the current fiscal year. Although he would be a general partner, sharing in income from all sources, he would have no part in any work done for the client-registrant and would not be located in the same city as the client's head office.

## II. Other Relationships and Conditions Prompting Inquiries as to Independence

37. Registrants A and B each own 50 percent of the outstanding stock of Company C, but are otherwise not related. The accounting firm which audits Registrant A would not be disqualified because of ownership of a small number of shares of stock of Registrant B. However, the accounting firm which audits Company C would not be considered independent if any of its partners had an interest in either Registrant A or B.

38. Partners in an accounting firm owned stock in a company in which a substantial minority

interest was owned by a client. Both companies were large and their securities were listed on a national securities exchange.

39. One of two partners of an accounting firm formed in February 1955 and dissolved in February 1956, became secretary-treasurer of a company in July 1955. He retained no interest in the partnership. The accounting practice was continued by the other partner who was engaged to make a first audit of the company in June 1956.

40. An accountant was co-executor of an estate which held approximately 15 percent of the outstanding shares of stock of a registrant. He had audited registrant's accounts for several years prior to the latest fiscal year. Another accountant had been engaged to certify the financial statements of the latest year for inclusion in a registration statement. The estate was being terminated and the registrant proposed engaging the accountant as auditor for subsequent years.

41. A staff member who had prepared financial statements for a mining company in the development stage and had participated in the audit was offered a position as an officer prior to the filing of a registration statement. Acceptance of the position by the staff member would not of itself destroy the independence of the accounting firm in connection with the proposed registration statement.

42. Accountants had installed an accounting system and prepared tax returns for a registrant prior to being engaged to certify financial statements to be included in a registration statement.

43. In addition to certifying the financial statements of a registrant, the accountant reviewed certain transactions of prior years, prepared fixed asset subsidiary ledgers, prepared the annual report to the state of incorporation, made recommendations for adjustments, and when consulted gave his professional opinion on the accounting treatment of particular transactions.

44. Due to the unexpected resignation of registrant's comptroller at the end of the year, the accountant was called upon to provide assistance in closing the books for the year. The work performed did not involve making decisions on a managerial level.

45. Following the death of the registrant's bookkeeper, an accounting firm posted the general ledger from the books of original entry and pre-

pared a periodic financial statements for the last 8 months of the fiscal year. Registrant's bookkeeping staff had full charge of accounting journals and subsidiary ledgers and recorded all transactions. Financial statements certified by the accounting firm were accepted, but the accountants were advised to discontinue the bookkeeping services immediately.

46. A company operating hotels requested an accounting firm to assign to a hotel one of their senior accountants, experienced in hotel auditing, to make a continuous audit of transactions from day to day. The individual assigned to this work was not to administer the accounting office or to sign checks of the company, and he would not be required to make any entries in the books of account. The hotel had on its staff another person with the title of chief accountant whose duty it would be to administer the accounting office and to maintain the books of account.

#### BROKER-DEALER REPORTS

The revision of the broker-dealer reporting requirements effective November 15, 1957,<sup>6</sup> requires that all but a limited number of these reports be certified by independent accountants. Certification is required primarily in the interest of safeguarding the funds and securities of customers and consequently a more detailed audit is required than that ordinarily made in a regular annual audit of a commercial or industrial company for preparation of the annual report to security holders.

The following are examples of representative situations in which an accountant has been held to be *not independent* with respect to a broker-dealer client:

47. A partner of the accounting firm which certified the financial statements of a registered broker-dealer was a partner in the registrant.

48. An accountant certified the financial statements of a brokerage firm in which his father and uncle were officers and owners of substantially all the outstanding stock.

49. An accountant certified the financial statements of a small brokerage firm in which his brother was a partner.

50. An accounting firm which had certified the financial statements of a registered broker-dealer for several years took the son-in-law of an officer of the registrant into their partnership.

51. A partner of the accounting firm which had certified the financial statements of a registered broker-dealer loaned securities to a partner of the registrant. The latter was the brother-in-law of the accountant. The securities were put in the firm's capital account and were used as part of the collateral securing a bank loan.

52. An accountant certified financial statements filed with the Commission by securities dealers. While considering an offer to serve as salesman for one of the securities dealers he inquired as to whether this would affect his independence with respect to dealers other than his prospective employer as to whom he acknowledged his lack of independence. He was advised that accepting such employment would place him in position of engaging in a line of endeavor incompatible with that of an independent public accountant.

53. An accountant certifying the financial statements of a registered broker-dealer was a co-signer on the broker's indemnity bond.

54. An accounting firm was advised that the effecting of cash transactions in securities with a broker-dealer client ordinarily would not be cause for questioning its independence with respect to such client. However, if as a result of such transactions a partner becomes indebted to the broker-dealer or becomes a creditor of the broker-dealer by leaving funds or securities on deposit, then the independent status of the accounting firm becomes questionable.

<sup>6</sup> Securities Exchange Act of 1934, Release No. 5560.

## APPENDIX

## Principal References Concerning the Practice of Accountants Before the Commission

## OPINIONS AND ORDERS OF THE COMMISSION

Cornucopia Gold Mines, 1 SEC (1936)  
 American Terminals and Transit Company, 1 SEC 701 (1936)  
 Interstate Hosiery Mills, Inc., 4 SEC 706 (1939)  
 A. Hollander & Son, Inc., 8 SEC 586 (1941)  
 Abraham H. Puder and Puder and Puder, Securities Exchange Act of 1934 Release No. 3073 (1941)  
 Southeastern Industrial Loan Company, 10 SEC 617 (1941)  
 Kenneth N. Logan, 10 SEC 982 (1942) (Accounting Series Release No. 28)  
 Associated Gas and Electric Company, 11 SEC 975 (1942)  
 C. Cecil Bryant, 15 SEC 400 (1944) (Accounting Series Release No. 48)  
 Red Bank Oil Company, 21 SEC 695 (1946)  
 Drayer-Hanson, Incorporated, 27 SEC 838 (1948)  
 Cristina Copper Mines, Inc., 33 SEC 397 (1952)  
 Coastal Finance Corporation, 37 SEC 699 (1957)

## ACCOUNTING SERIES RELEASES

No. 2 (1937) Independence of accountants—Relationship to registrant.  
 No. 19 (1940) McKesson & Robbins, Inc.  
 No. 22 (1941) Independence of accountants—Indemnification by registrant.  
 No. 28 (1942) Kenneth N. Logan, 10 SEC 982.  
 No. 47 (1944) Independence of certifying accountants—Summary of past releases of the Commission and a compilation of hitherto unpublished cases or inquiries.  
 No. 48 (1944) C. Cecil Bryant, 15 SEC 400.  
 No. 51 (1945) Disposition of Rule II(e) proceedings against certifying accountant.  
 No. 59 (1947) Williams and Kingsolver.

National Boston Montana Mines Corporation, 2 SEC 226 (1937)  
 Rickard Ramore Gold Mines, Ltd., 2 SEC 377 (1937)  
 Metropolitan Personal Loan Company, 2 SEC 803 (1937)  
 No. 64 (1948) Drayer-Hanson, Incorporated, 27 SEC 838.  
 No. 67 (1949) Barrow, Wade, Guthrie & Co., Henry H. Dalton and Everett L. Mangam.  
 No. 68 (1949) F. G. Masquelette & Co., and J. E. Cassel.  
 No. 73 (1952) Haskins & Sells and Andrew Stewart.  
 No. 77 (1954) Disposition of Rule II(e) proceedings against certifying accountant.  
 No. 78 (1957) Touche, Niven, Bailey & Smart, et al., 37 SEC 629.

## CHANGES IN THE INDEPENDENCE RULE

Article 14, Rules and Regulations under the Securities Act of 1933,<sup>1</sup> Federal Trade Commission, July 6, 1933.  
 Article 41, Rules, Regulations and Opinions under the Securities Act of 1933 as Amended, April 29, 1935.  
 Rule 650, General Rules and Regulations under the Securities Act of 1933, January 21, 1936.  
 Rule 2-01, Regulation S-X, Adopted February 21, 1940, Accounting Series Release No. 12.  
 Amendments of Rule 2-01:  
 Accounting Series Release No. 37, November 7, 1942.  
 Accounting Series Release No. 44, May 24, 1943.  
 Accounting Series Release No. 70, December 20, 1950.  
 Accounting Series Release No. 79, April 8, 1958.

<sup>1</sup> The Securities and Exchange Commission was established under provisions of the Securities Exchange Act of 1934 and was authorized to continue in effect until modified all rules and regulations issued by the Federal Trade Commission under the Securities Act of 1933.

## RELEASE NO. 82

January 28, 1959

**Findings and Opinion of the Commission In the Matter of Boltt and Shapiro, Theodore Boltt, and Bernard L. Shapiro, proceeding pursuant to Rule II(e), Rules of Practice.****ACCOUNTING—PRACTICE AND PROCEDURE**

Denial and Suspension of Privilege to Practice Before Commission

Lack of Independence by Accountant

Causing Non-Independent Accountant to Certify Financial Statement

Where partner of accountant certifying financial statement in registration statement filed with Commission pursuant to Securities Act of 1933 is the principal officer and controlling stockholder of the registrant, *held*, certifying accountant is not independent with respect to registrant.

Where one partner in firm of certified public accountants who was the principal officer and controlling stockholder of company which filed a registration statement with the Commission caused the other partner to certify registrant's financial statement as an independent public accountant, *held*, firm and both partners engaged in improper and unethical professional conduct, and privilege of practicing before the Commission should be denied to the firm and the partner controlling registrant until they obtain the approval of the Commission, and the privilege to practice before the Commission of the certifying accountant should be suspended for 30 days.

**APPEARANCES:**

*Ellwood L. Englander*, and *Alger B. Chapman, Jr.*, of the Office of the General Counsel, for the Office of the Chief Accountant of the Commission.

*Francis T. Green*, of Surrey, Karasik, Gould and Efron, for respondents.

**FINDINGS AND OPINION OF THE COMMISSION**

These are proceedings under Rule II(e) of our Rules of Practice to determine whether Boltt and Shapiro, a partnership of certified public accountants ("B&S"), and Theodore Boltt and Bernard L. Shapiro, the partners therein, should be denied, temporarily or permanently, the privilege of appearing or practicing before us.<sup>1</sup>

<sup>1</sup> Rule II(e) provides:

The Commission may disqualify, and deny, temporarily

The order instituting these proceedings alleges that respondents engaged in unethical and improper professional conduct in that Shapiro certified as an independent accountant the financial statement included in a registration statement filed by a company of which his partner Boltt was the promoter, principal officer and controlling stockholder, and in that Boltt and Shapiro sought to conceal from us their relationship as partners in their accounting firm.

Respondents filed an answer to the order for proceedings, and after appropriate notice a private hearing was held before a hearing examiner. Proposed findings, briefs and reply briefs were filed by the respondents and by the Office of the General Counsel on behalf of the Chief Accountant of the Commission ("Staff"). The hearing examiner submitted a recommended decision in which he concluded that B&S, Boltt and Shapiro had engaged in unethical conduct and recommended that each of them be denied the privilege of practicing before us for a period of 15 days. Thereafter, exceptions and a supporting brief were filed by the respondents, and exceptions and a reply brief were filed by the Staff, and we heard oral argument. On the basis of an independent review of the record we make the following findings and conclusions.

Boltt and Shapiro are certified public accountants and members of the American Institute of Certified Public Accountants ("AICPA"). Boltt has been a certified public accountant since 1942 and Shapiro since 1948. The partnership was formed in 1951, and its clients are mainly small closely-held businesses, none of which has securities widely held by public investors. Most of the firm's clients were obtained through Boltt.

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or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after hearing in the matter—

(1) not to possess the requisite qualifications to represent others; or

(2) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct.

Bolt is the principal promoter, president, treasurer, director, and owner of the majority of the voting stock of the Motel Corporation of Italy ("registrant"), whose address is the same as that of the respondent partnership. In January 1958 Bolt caused registrant to file a registration statement<sup>2</sup> under the Securities Act of 1933 ("Act"), covering a proposed public offering of securities having an aggregate offering price of approximately \$1 million. The registration statement included registrant's balance sheet, which was certified by Shapiro as a certified public accountant. The registration statement was withdrawn after registrant was advised by our Division of Corporation Finance ("Division") that such statement failed to meet the requirements of the Act.<sup>3</sup>

#### Lack of Independence of Certifying Accountant

Schedule A of the Act, which specifies the information and documents required in a registration statement, provides that financial statements be furnished which are certified by an independent public or certified accountant. Rule 2-01 of our Regulation S-X states that we will not recognize any accountant as independent who is not in fact independent, and cites as an example that an accountant will be considered not independent with respect to any person or any affiliate thereof in whom he has a financial interest or with whom he is connected as a promoter, director, officer or employee. The rule further states that in determining whether or not an accountant is in fact independent with respect to a particular registrant, we will give appropriate consideration to all relevant circumstances, including all relationships between the accountants and that registrant or any affiliate of that registrant,<sup>4</sup> and will not confine ourselves to the relationship existing in connection with the filing of documents with us.

Shapiro's relationship as a partner of Bolt, who is a promoter, director, officer, and con-

trolling stockholder of registrant and therefore an affiliate thereof, rendered him not independent with respect to registrant and accordingly disqualified him from certifying its financial statement. This is clear not only from a reading of Rule 2-01 but also from our prior decisions and published releases.

In *Rickard Ramore Gold Mines, Ltd.*, we held that an accountant who was an employee or a partner of another accountant who was a substantial stockholder of a company was not independent with respect to certifying that company's financial statements. We stated that the purpose and intent of the requirement of certification by an independent accountant would be defeated and evaded if the stockholder-accountant is disqualified but his partner or employee is not.<sup>5</sup> Under this principle we have held that an accounting firm could not be considered independent for the purpose of certifying the financial statements of a corporation in which one member of the accounting firm owned a substantial amount of stock.<sup>6</sup> The same conclusion of nonindependence was reached when one partner of the accounting firm merely served as a member of the board of directors, even though such partner did not participate in any way in the audit and another partner certified the financial statement in his own and not the firm's name.<sup>7</sup>

Rule 13 of the Rules of Professional Conduct of the AICPA provides that a member shall not express an opinion on financial statements of any enterprise financed by the public distribution of securities if he or his immediate family has a substantial financial interest in such enterprise. As respondents concede, this rule, as interpreted by the Committee on Professional Ethics of the AICPA, precludes a public accountant from rendering an opinion with respect to an enterprise financed through the public distribution of securities if his partner in the practice of accounting has a substantial interest in the enterprise.<sup>8</sup>

The lack of independence of a partner in a public accounting firm affects the partnership and

<sup>2</sup> File No. 2-13845.

<sup>3</sup> A prior registration statement (File No. 2-13789) had also been withdrawn by registrant after it had been advised by our Division that such statement failed to meet the requirements of the Act. Among other asserted deficiencies, the prior statement failed to include an accountant's certificate with respect to the financial statements therein.

<sup>4</sup> Under Rule 1-02 of Regulation S-X, an affiliate of a specified person is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

<sup>5</sup> 2 S.E.C. 377, 389 (1937).

<sup>6</sup> Accounting Series Release No. 2 (May 6, 1937). (See p. 2.)

<sup>7</sup> See Accounting Series Release No. 47 (January 25, 1944), Examples Nos. 8 and 9. (See p. 62.)

<sup>8</sup> Interpretation of Rule 13, *CPA Handbook*, American Institute of Accountants, Vol. I. App. A, pp. 7-8.

every other partner. Bollt himself was admittedly not qualified to give an independent report on the financial statements of the Company he controlled; we find that his partner Shapiro and the partnership itself were equally lacking in the requisite independent capacity.

#### **Unethical and Improper Professional Conduct**

Respondents contend that we should not find them to have engaged in unethical or improper professional conduct. They assert that Bollt and Shapiro had had no prior experience with matters before us, were unfamiliar with our rules, decisions and releases and the interpretation of the AICPA regarding independence, and in good faith concluded that Shapiro could be considered independent because he himself had no financial interest in or position with registrant.

#### **Bollt and B&S**

Bollt recognized that he himself was not qualified, because of his substantial financial interest and controlling position, to furnish an independent report regarding registrant's financial statement. He testified that he discussed the selection of Shapiro to certify the financial statement with his attorney, Sol M. Alpher, who helped prepare the registration statement and who was also secretary and a director of registrant and signed the registration statement. Bollt asserted that he was familiar with the AICPA rule, but had not read our rules or decisions or the AICPA interpretation of its rules regarding independence of public accountants, nor had he made any inquiries of our Staff. Instead he relied on Alpher's opinion that Shapiro was independent within the intent of the registration requirements.

In our opinion any common sense interpretation of independence would have led to the conclusion that the partner of the promoter and controlling stockholder of an enterprise is not independent with respect to the enterprise, and the parties concerned should have realized that at the very least such a relationship should be disclosed. We consider it significant in this connection that nowhere in the registration statement was any mention or disclosure made of the fact that Bollt and Shapiro were partners, although such information was required in response to one item in the registration statement and this fact or the fact that they had a common business address could have been reason-

ably expected to be mentioned in two other places.

Bollt signed the registration statement as a principal officer and director of registrant. One item of the registration statement, entitled "Relationship with Registrant of Experts Named in Registration Statement," calls for the disclosure of any substantial interest in registrant or its parents of the accountant certifying the financial statements. Bollt, as a person who controlled registrant, was a parent of registrant within the definition thereof in Rule 1-02, and Shapiro, in view of his partnership with Bollt, had a substantial interest in Bollt. Yet no disclosure of the partnership was made.

Under another section of the registration statement entitled "Management," there is a biographical description of registrant's officers and directors including Bollt. The description of Bollt lists his business activities and membership in fraternal and civic and professional groups, but omits any reference to his partnership with Shapiro and merely stated that he is in "active practice in Maryland as a Certified Public Accountant." While there is no specific requirement that the partnership be mentioned at that point, the omission is significant in view of the detailed list of Bollt's other activities and affiliations.

Finally, Shapiro's certificate included in the registration statement was not on the partnership's printed letterhead but on a blank sheet of paper upon which Shapiro's home address was typed. Alpher testified that he inserted Shapiro's home address in order to indicate that Shapiro was acting in his individual capacity and not as a partner in B&S. However, had Shapiro's business address been used, his relationship with Bollt and registrant would have been apparent, since all of them have the same business address and the business address of Bollt and registrant is listed in the registration statement.

Bollt asserts that he was unfamiliar with our rules and decisions on independence, as well as with the interpretation of the AICPA rules thereon; that he delegated to Alpher the task of preparing the registration statement and resolving all related legal problems, and relied on Alpher's determination that Shapiro was independent; that the partnership between Bollt and Shapiro was a matter of public record and was disclosed in listings in the local telephone and accountants' directories; and that Bollt carelessly signed the registration statement without noticing the omissions respect-

ing the partnership relationship, and did not designedly conceal the partnership relationship or cause Shapiro to certify the balance sheet notwithstanding his lack of independence.

We do not find these assertions persuasive, and we agree with the findings of the hearing examiner that Bolt caused his accounting partner Shapiro to certify as an independent accountant the balance sheet of a registrant controlled by Bolt, and that Bolt attempted to conceal from us and the public his relationship with Shapiro.<sup>9</sup> In view of the complete omission from the registration statement of any mention of Bolt's relationship with Shapiro or of any fact, such as a common business address, which might have suggested any such relationship, we are convinced that Bolt recognized Shapiro was not qualified to furnish an independent certification and sought to conceal this from us and from the purchasers.<sup>10</sup> We conclude that Bolt and B&S engaged in unethical and improper professional conduct in connection with the certification of registrant's balance sheet by Shapiro.

### Shapiro

Shapiro knew that he was certifying registrant's balance sheet for inclusion in a registration statement which was to be filed under the Act in connection with a proposed offering to public investors of approximately \$1 million of securities, and that such certification was required to be that of an independent public accountant. Shapiro testified that he had read Rule 13 of the Rules of Professional Conduct of the AICPA, which does not on its face specifically refer to the situation of a partner of an affiliate of a registrant, but that he did not know of the published interpretation of that rule which did relate to such situation, and that, after discussing the question with Alpher, he relied on the latter's opinion that he was qualified to certify registrant's balance sheet notwithstanding his partnership with Bolt.

<sup>9</sup> Bolt testified that he disclosed the partnership with Shapiro in a conference with members of the Division after the filing of the registration statement. The staff members present testified, however, that no such disclosure was made.

<sup>10</sup> Respondents imply that Alpher himself may have tried to conceal from us the partnership relationship, and assert that Bolt was unaware of any such scheme on Alpher's part and should not be held responsible therefor. However, it is not reasonable under all the circumstances to believe that the attorney would embark upon such a course of conduct in behalf of his client without the client's knowledge and acquiescence.

Shapiro was charged with the professional responsibility of familiarizing himself with our accounting and auditing rules to which his client was subject.<sup>11</sup> He was aware that his partnership with the person who controlled registrant was material to the question of his independence, and he should have realized that it precluded him from certifying registrant's financial statement. Any doubt in Shapiro's mind could have been easily resolved by recourse to our rules, accounting releases, published opinions, the interpretation of the rules of the AICPA, and the informal advice of our Staff, any one of which would have indicated to him the lack of independence. Instead he merely accepted the opinion of Alpher who was an officer and director of and an attorney for the very enterprise as to which Shapiro was required to be independent.

We conclude that Shapiro engaged in improper professional conduct in not inquiring into and becoming familiar with our requirements regarding independence, in relying on the opinion of Alpher, and in certifying registrant's balance sheet as an independent public accountant when he was not in fact independent with respect to registrant either under our rules or under generally accepted accounting standards.

The hearing examiner did not find that Shapiro sought to deceive us. We are in accord with the hearing examiner in this respect, and we find that the record, which shows that Shapiro did not participate in the preparation of the text of the registration statement and that his home address rather than the firm address was placed on his report after he signed it and without his knowledge, does not establish that Shapiro sought to conceal from this Commission his relationship with Bolt.

### CONCLUSIONS

Respondents urge that disciplinary action is not required. They point to the fact that registrant's balance sheet was a short and simple document and no charge has been made with respect to its adequacy or accuracy and contend that in other cases in which we have taken disciplinary action against public accountants we found that

<sup>11</sup> Cf. *CPA Handbook*, American Institute of Accountants, Volume I, Chapter 5, pp. 23-24, where it is stated that an accountant who has failed to familiarize himself with the accounting or auditing rules of a government agency affecting his client may be subject to discipline.

the financial statements themselves contained false or misleading representations.

The requirement in the Act that certification be by an independent accountant is a basic one and reflects the importance to investors and the public of an audit by accountants not connected with the company or its management.<sup>12</sup> That registrant's balance sheet was not complex and its accuracy and completeness have not been questioned in these proceedings, does not either cure or reduce the importance of the lack of independence by the certifying accountant.<sup>13</sup>

The false representation of independence of a certifying accountant constitutes serious improper professional conduct and provides a basis for disciplinary action. In taking disciplinary action against an accountant on the ground, among other things, that he was not independent of his client, we stated in *Kenneth N. Logan* that, when an accountant who is in fact lacking in independence represents, by his certifications to be filed with us, that he is independent, that circumstance is relevant to the issue of his character and integrity and the propriety and ethics of his professional conduct.<sup>14</sup>

Even apart from the requirements of the Act and of our rules, it is firmly established under generally accepted accounting standards that independence is the keynote of the public accounting profession.<sup>15</sup> Authorities in the profession have repeatedly stressed that the public accountant's primary asset is his independence and integrity, and that he is impelled not only by enlightened self-interest, but also by rules of professional

conduct, to maintain his independence at all costs.<sup>16</sup>

Bolt's conduct, which as we have found involved a deliberate concealment of the partnership relationship between him and Shapiro, whom he caused to certify the financial statements despite such relationship, requires that we exclude him and his firm from practicing before us. In the case of Shapiro, as to whom no intentional concealment has been established, he evidenced a careless and unprofessional attitude with respect to a most fundamental concept under both the Act and accounting standards.

After a careful consideration of all pertinent factors, including those stressed by respondents, we are of the opinion that respondents Bolt and B&S should not be permitted to practice before this Commission in the future until they obtain our approval, and that respondent Shapiro should be denied the privilege of practicing before us for a period of 30 days.

#### Rulings on Exceptions

We have examined the recommended decision of the hearing examiner and the exceptions thereto, and to the extent such exceptions involve issues which are relevant and material to the decision in this case, we have by our opinion herein already fully ruled upon them. We hereby expressly sustain those exceptions to the extent that they are in accord with the views set forth herein, and we expressly overrule those exceptions to the extent that they are inconsistent with such views.

An appropriate order will issue.

By the Commission (Chairman GADSBY and Commissioners ORRICK, PATTERSON, and SARGENT), Commissioner HASTINGS being absent and not participating.

ORVAL L. DUBOIS,  
*Secretary.*

<sup>12</sup> See *Cornucopia Gold Mines*, 1 S.E.C. 364, 367 (1936); Accounting Series Release No. 22 (March 14, 1941).

<sup>13</sup> See *A. Hollander & Son, Inc.*, 8 S.E.C. 586, 613 (1941), where, in a stop order proceedings, we stated:

"We cannot, however, accept the theory advanced by counsel for the intervenors that lack of independence is established only by the actual coloring or falsification of the financial statements or actual fraud or deceit. To adopt such an interpretation would be to ignore the fact that one of the purposes of requiring a certificate by an independent public accountant is to remove the possibility of impalpable and unprovable biases which an accountant may unconsciously acquire because of his intimate nonprofessional contacts with his client. The requirement for certification by an independent accountant is not so much a guarantee against conscious falsification or intentional deception as it is a measure to insure complete objectivity."

<sup>14</sup> Accounting Series Release No. 28 (January 8, 1942).

<sup>15</sup> The council of the AICPA has stated:

"Independence, both historically and philosophically, is the foundation of the public accounting profession, and upon its maintenance depends the profession's strength and its stature . . . It has become of great value to those who rely on financial statements of business enterprises that they be reviewed by persons skilled in accounting whose judgment is uncolored by any interest in the enterprise . . ."

*CPA Handbook*, American Institute of Accountants, Ch. 5, pp. 16-17.

<sup>16</sup> *Montgomery's Auditing* (7th Ed., 1949), p. 22; Address by the Research Director of the AICPA, printed in the *Journal of Accountancy*, December 1946, p. 453.

**ORDER DENYING PRIVILEGE OF PRACTICING BEFORE COMMISSION**

Proceedings having been instituted pursuant to Rule II(e) of the Commission's Rules of Practice to determine whether Boltt and Shapiro, a firm of certified public accountants, and Theodore Boltt and Bernard L. Shapiro, partners in said firm, should be disqualified or denied, temporarily or permanently, the privilege of appearing or practicing before this Commission;

A private hearing having been held after appropriate notice, the hearing examiner having filed a recommended decision, exceptions thereto and briefs having been filed, and oral argument having been heard;

The Commission having this day issued its Findings and Opinion, on the basis of said Findings and Opinion

IT IS ORDERED, pursuant to Rule II(e) of the Rules of Practice, that Boltt and Shapiro, and Theodore Boltt be, and they hereby are, denied the privilege of practicing before the Commission unless and until they shall have obtained the prior approval of the Commission.

IT IS FURTHER ORDERED that Bernard L. Shapiro be, and he hereby is, denied the privilege of practicing before the Commission for a period of 30 days from the date hereof.

By the Commission.

ORVAL L. DuBois,  
*Secretary.*

**RELEASE NO. 83**

October 28, 1959

**SECURITIES EXCHANGE ACT OF 1934**

Release No. 6102

**Amendment to Minimum Audit Requirements prescribed in Form X-17A-5 under the Securities Exchange Act of 1934**

On September 18, 1959, in Securities Exchange Act of 1934 Release No. 6072 the Securities and Exchange Commission announced that it had under consideration a proposed amendment to the Note to Item 5 of the Minimum Audit Requirements to be followed by independent accountants in preparing Form X-17A-5 reports of financial condition of members, brokers and dealers under Rule 17a-5 under the Securities Exchange Act of 1934. The Commission has considered all of the views and comments received on the proposal and has adopted the amendment in the form stated below.

Item 5 of the Minimum Audit Requirements provides that the independent accountant shall request written confirmation of certain accounts, including customers' accounts, of the member, broker or dealer. The amendment to the Note to Item 5 of the Minimum Audit Requirements of Form X-17A-5 specifically permits the certifying accountant in auditing the books and records of member firms of national securities exchanges who originate Monthly Investment Plan accounts to

omit, under specified conditions, written confirmation of the M.I.P. accounts of the originating member firm required by Item 5 when in his judgment such procedure is not necessary. The amendment does not relieve the certifying accountant of the responsibility for requesting written confirmation of any other accounts of M.I.P. customers, or for a satisfactory verification of the M.I.P. accounts of the originating broker, or for the review of the safeguards of such accounts, or for the responsibility for performing such other auditing procedures as are ordinarily performed in the audit of the customers' accounts of a broker-dealer.

The New York Exchange in its minimum audit requirements specifies that each odd-lot firm which acts as custodian of securities owned by M.I.P. customers have an audit on a surprise basis by an independent public accountant made at least once in each calendar year. Audits of the originating member firms must also be made on a surprise basis each calendar year. The Committee on Audits of Securities Brokers and Dealers of the

American Institute of Certified Public Accountants feels, and the Exchange agrees, that the duplication of the confirmation procedures has entailed an audit expense which does not appear to be justified and that duplicate confirmation is confusing to the customers. Because of this confusion and in view of the internal control inherent in M.I.P. accounting, the committee recommended that under certain conditions the independent public accountants concerned with the audits of the respective originating member firms (commission houses) be relieved of the procedure for requesting written confirmation of M.I.P. accounts to the extent that, in their judgment, such procedure is not necessary. The conditions specified by the committee are:

1. The independent public accountants who have been retained as auditors for the odd-lot houses will select the same audit date for a surprise examination of the respective odd-lot houses. (We understand this is now being done.) This will ensure that those customers having M.I.P. accounts with both odd-lot houses will receive requests for confirmations of their accounts as of the same date.

2. The odd-lot houses, at the time of the examination by independent public accountants, will prepare listings for each commission house of the M.I.P. accounts that they are maintaining for the commission firms. This will enable the commission houses and the odd-lot houses to establish a procedure where not only will confirmations of the customers' accounts be requested as of one audit date but, as of the same audit date, confirmations will be requested from the commission houses as to the positions maintained by the custodians.

3. The independent public accountants who have been retained as auditors for the commission houses will satisfy themselves that the listings prepared by the odd-lot houses, of funds and securities held for M.I.P. customers at the time of the examination of the odd-lot houses by independent public accountants, have been reconciled with the records of the commission houses.

#### STATUTORY BASIS AND TEXT OF AMENDMENT

The Securities and Exchange Commission, acting pursuant to the provisions of the Securities Exchange Act of 1934, particularly Sections 17(a) and 23(a) thereof, and deeming such action

necessary and appropriate in the public interest and for the protection of investors and necessary for the execution of its functions under the Act, hereby amends the Note to Item 5 of the Minimum Audit Requirements of Form X-17A-5 as stated below. The Commission finds that such action has the effect of relieving restriction and granting exemption and that under the provisions of Section 4(c) of the Administrative Procedure Act it may be and is hereby declared effective Wednesday October 28, 1959.

The text of the Note to Item 5, as amended, is as follows:

"Compliance with requirements for obtaining written confirmation with respect to the above accounts shall be deemed to have been made if requests for confirmation have been mailed by the independent public accountant in an envelope bearing his own return address and second requests are similarly mailed to those not replying to the first requests, together with such auditing procedures as may be necessary: *Provided, however,* That with respect to periodic investment plans sponsored by member firms of a national securities exchange, whose members are exempted from Rule 15c3-1 by paragraph (b) (2) therefore, the independent public accountant examining the financial statements of the originating member firm may omit direct written confirmation of such plan accounts with customers when, in his judgment, such procedures are not necessary, if (1) the originating member firm does not receive or hold securities belonging to such plan accounts and does not receive or hold funds for such accounts, except the initial payment which is promptly transmitted to the custodian; (2) the custodian is a member firm of such national securities exchange and files certified reports complying with Rule 17a-5 in connection with which the customers' accounts are confirmed by an independent public accountant; and (3) funds and securities held by the custodian for each such customer's account are reconciled with the records of the originating member firm as of the date of the most recent audit of the custodian."

By the Commission.

ORVAL L. DuBOIS,  
*Secretary.*